INVESTMENT TRUSTS AND INVESTMENT COMPANIES

REPORT

OF THE

SECURITIES AND EXCHANGE COMMISSION

PURSUANT TO SECTION 30 OF
THE PUBLIC UTILITY HOLDING COMPANY ACT OF 1935

PART THREE

CHAPTER VI

Abuses and Deficiencies in the Organization and Operation of Investment Trusts and Investment Companies

WASHINGTON, D. C.

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LETTER OF TRANSMITTAL

SECURITIES AND EXCHANGE COMMISSION,
Washington, D. C., September 10, 1940.

SIR: I have the honor to transmit herewith Chapter VI of Part Three of the Commission's over-all report on the study of investment trusts and investment companies made pursuant to Section 30 of the Public Utility Holding Company Act of 1935. Chapter VI deals primarily with accounting practices and reports to stockholders generally, and contains a description of the activities and accounting practices of the United Founders group.

The study and report were under the general supervision of Commissioner Robert E. Healy, with Paul P. Gourrich, former technical adviser to the Commission, as director of the study; the late William R. Spratt, Jr., as chief of the study; David Schenker as counsel; and L. M. C. Smith as associate counsel. Mr. Justice Douglas, former Chairman of the Commission, whose resignation from the Commission was submitted on April 14, 1939; Paul P. Gourrich, former director of the study, whose resignation from the Commission was submitted on March 31, 1939; and William R. Spratt, Jr., former chief of the study, whose death occurred on June 20, 1938, did not participate in the preparation or consideration of Part Three.

Chapter VI was prepared under the immediate supervision of Benjamin Levy and Edmond G. Blumner, with the collaboration of Charles M. Kollin and Alfred Berman.

By direction of the Commission:

JEROME N. FRANK, *Chairman.*

THE PRESIDENT OF THE SENATE.
THE SPEAKER OF THE HOUSE OF REPRESENTATIVES,
Washington, D. C.

LIST OF REPORTS SUBMITTED

Part One, Part Two, and Chapters I to V, inclusive, of Part Three of the over-all report have heretofore been transmitted by the Commission to the Congress. Part One, which was transmitted by the Commission to the 75th Congress on June 10, 1938, consists of a discussion of the nature, classification, and origins of investment trusts and investment companies, and has been printed as House Document No. 707, 75th Congress. Part Two, the transmission of which to the 76th Congress was completed on March 10, 1939, consists of a statistical survey of investment trusts and investment companies and has been printed as House Document No. 70, 76th Congress.

Chapter VI, herewith transmitted to the 76th Congress, completes the material of Part Three which is printed as House Document No. 279, 76th Congress. Chapter VII completes Part Three and was transmitted to the 77th Congress and ordered printed as House Document No. 136. Part Three deals with the abuses and deficiencies in the organization and operation of investment trusts and investment companies.

The Commission has also transmitted to the Congress six supplemental reports, namely: Investment Trusts in Great Britain, transmitted on June 26, 1939, and printed as House Document No. 380, 76th Congress; Investment Counsel, Investment Management, Investment Supervisory, and Investment Advisory Services, transmitted on August 17, 1939, and printed as House Document No. 477, 76th Congress; Commingled and Common Trust Funds Administered by Banks and Trust Companies, transmitted on August 30, 1939, and printed as House Document No. 476, 76th Congress; Companies Sponsoring Installment Investment Plans, transmitted on September 22, 1939, and printed as House Document No. 482, 76th Congress; Fixed and Semifixed Investment Trusts, transmitted on January 15, 1940, and printed as House Document No. 567, 76th Congress; and Companies Issuing Face Amount Installment Certificates, transmitted on March 13, 1940, and printed as House Document No. 659, 76th Congress.

TABLE OF CONTENTS

PART THREE

Chapter VI—Accounting Practices of Investment Companies, Independent Public Accountants, and Reports to Stockholders Generally

LIST OF APPENDIXES

Chapter VI

LIST OF TABLES

Chapter VI

LIST OF CHARTS

Chapter VI

CHAPTER VI

ACCOUNTING PRACTICES OF INVESTMENT COMPANIES, INDEPENDENT PUBLIC ACCOUNTANTS, AND REPORTS TO STOCKHOLDERS GENERALLY—ACCOUNTING PRACTICES OF THE UNITED FOUNDERS CORPORATION GROUP OF COMPANIES WITH A DESCRIPTION OF THEIR ACTIVITIES

SCOPE OF THE CHAPTER

Among the most important and serious problems developed in the Commission's study of investment trusts and investment companies were those relating to their accounting practices and reports to stockholders. Information concerning these major problems was obtained through detailed questionnaires, field examinations of the books and records of certain companies, a survey of their reports to stockholders, and testimony of the accountants and managements of investment companies at the public examinations conducted before the Commission. In general this accounting survey covered the years 1927 through 1935, but in exceptional instances years prior to 1927 were taken into account.

In the present chapter certain significant categories of accounting practices and procedures relating to management investment companies,[1] have been set forth and reviewed. An exhaustive compilation in this chapter of all the data and observations obtained from the examination of the accounting practices of the entire group of management investment companies within the purview of the study did not seem feasible. It was thought, instead, that a clear and comprehensive presentation could best be made through a twofold approach: (a) by examining in broad and co-related form specific accounting problems found within a representative cross-section of the investment company industry comprised of 76 management type investment companies,[2] and (b) by considering in a detailed manner the accounting practices

[1] The accounting practices of fixed trusts, installment investment plans and face amount installment certificate companies are not discussed in this chapter. The practices of "closed-end" management type companies are separated from those of "open-end" companies at a number of points in this chapter because of certain important distinctions in regard to capital structure between the two groups. (See Part One (House Doc. No. 707, 75th Cong.), Ch. II, pp. 26–7.)

[2] These 76 companies, which comprised approximately one-third of the total number of management type investment companies replying to the Commission's questionnaire, are listed in Appendix J, p. 2407. Of this number, 62 are of the "closed end" type and 14 are of the "open-end" type. Of these 76 companies, 64 were in existence at December 31, 1929, with resources aggregating approximately $2,200,000,000, and 73 were active on December 31, 1935, with resources approximating $1,200,000,000.

of the largest single investment company system in this country, the United Founders Corporation group.[3] Combination of the horizontal view obtained through the first method, with the vertical section afforded by the second, seemed properly adapted to produce an accurate and balanced picture.

In order to furnish a suitable background on which to project the review of the practices of the United Founders Corporation group, this chapter also contains an outline of the history and activities of that group, an account which has not been presented in any other part of the report.

Accordingly, the present chapter falls into three sections: (1) a general survey of the accounting practices of a representative cross-section of investment companies; (2) a description of the activities of the United Founders Corporation group of investment companies; and (3) a review of the accounting practices of the United Founders Corporation group.

I. GENERAL SURVEY OF ACCOUNTING PRACTICES AND REPORTS TO STOCKHOLDERS

A. Introduction

In the preceding chapters of this Part of the report an attempt has been made to portray the more important of the widespread abuses which were found to have contributed materially to the huge loss sustained by the public on the seven billion dollars entrusted to the management of investment companies.[4]

With this large industry almost completely unregulated and unsupervised,[5] information concerning these abuses and some protection against them might have been afforded the investing public had there been in general use a sound and recognized body of uniform accounting principles and practices.

The Commission's study of the accounting practices of investment companies has disclosed, however, that during the period studied there was almost completely lacking in the investment company industry any such recognized body of uniform accounting principles or practices. Instead there reigned such diversity and confusion that accountancy sometimes was transformed into an instrumentality by which abuses were both perpetrated and concealed rather than exposed.

It is clear that the managements of many investment companies, free from almost any restraint, favored those accounting practices in con-

[3] The public invested more than a half billion dollars, and suffered losses in excess of $370,000,000, in the securities of the companies of this group. This loss represented approximately one-third of the total net loss to investors in all management companies proper during the period 1927 through 1935.

[4] See especially Ch. II of this part of the report and Part Two (House Doc. No. 70, 76th Cong.), Ch. VII, pp. 497-517.

[5] A small measure of control in accounting matters was exercised through the listing requirements and the regulations of the New York Stock Exchange. However, prior to June 1929 the New York Stock Exchange refused to list the securities of investment trusts, and even after it agreed to do so, only a very limited number of investment companies availed themselves of the privilege. By the end of 1936, 31 management investment companies out of a total of 404 in existence had securities listed on the New York Stock Exchange and a total of 81 were listed on all registered exchanges. (Part Two (House Doc. No. 70, 76th Cong.), Table 87, p. 329.)

nection with their companies which were not in accordance with sound accounting principles, but rather according to whatever designs seemed to the managements best fitted to promote their immediate objectives, and the adaptability of one method or another to the accomplishment of these ends.

So great was the variety of accounting practices in use among the various companies that the terse terminology of the stockholders' report became either unintelligible or definitely misleading. The few short words which traditionally comprise the vocabulary of income statement and balance sheet—"income," "profit," "capital," "surplus"—were invested with such varied and conflicting significance that they afforded no true measure of the performance of the individual company, and rendered almost impossible accurate comparisons between companies.

For example, at least four different methods were available to investment companies in computing the cost of securities disposed of from a block which had been acquired at different times and prices.[6] Frequently, the use of one or another of these methods would result in the recording of a "profit" on the sale, while use of the others would have produced a loss. In consequence, it frequently occurred that a company which reported substantial earnings fundamentally had a performance no better than another company which reported a loss, due to the use of varying criteria of cost measurement. Moreover, from one year to the next, behind apparently identical earnings reported by a company, might lie very different results caused by a shift from one method of determining cost to another. In the same manner, and with like effect, securities carried in the portfolios of investment companies were valued in accordance with four distinct standards,[7] each of which affected investment and profit accounts differently.

Reports to stockholders were found to be deficient in numerous respects. Some were deficient in their failure to reveal the basis of computation of profits or losses upon sales of securities (whether based upon average cost, first-in, first-out, or on the identified security basis). In others there was a deception arising from the failure to qualify the amounts of profits and losses when portfolio securities had been disposed of after a write-down. In these cases, although proceeds from sales of securities were less than original cost, results were characterized as profits without qualification that they represented merely the proceeds in excess of written-down values. Likewise, trading losses were considerably understated when they were reported without explanation that they were not based upon original cost. By a failure in some instances to publish adequate analyses, reserve accounts became instrumentalities for covering up realized losses and for the distortion of trading results. Similarly inadequate analyses of surplus accounts in published reports led to the concealment of substantial realized losses.

Added to these deficiencies is the following list, by the cumulative effect of which the low standard of reports to stockholders of a large part of the investment company and investment trust industry during the period under review may be observed: inclusion of treasury securities in portfolio without disclosure; publication of portfolio at lower of

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[6] Average cost; first-in, first-out; last-in, first-out; specific identification.

[7] Cost; cost less reserve; adjusted book value representing written down value and cost of subsequent acquisitions; lower of cost or market.

cost or market without revealing cost; carrying and maintaining portfolio reserves unknown to stockholders; failure to break down expenses so as to reveal salaries and management fees; nondisclosure of brokerage commissions paid by companies sponsored by bankers and brokers; reporting of pledging of securities without stating dollar amount; failure to reveal amounts paid to stockholders in settlement of claims; concealment of short sales and short sales positions; omission of net asset values per share in multiple class stock companies; inclusion in a single amount of senior and junior capital, together with paid-in and earned surplus; failure to report amounts allocated to paid-in surplus upon disposition of capital stock; use of misleading terminology, such as: "cash in bank" and "certificates of deposit," which represented funds with a sponsor not a bank; "time loans secured by collateral," which pertained to capital stock held on option without obligation to pay the price unless the option were exercised; "profits on sales of securities," which as to a large part represented a diversion of paid-in capital of affiliated companies, and as to another large part represented the excess of proceeds over cost of securities disposed of by subsidiary companies to their parent; "dividends," which in large measure, as to one company, represented sales of rights, and which, as to another company, were received from a wholly owned subsidiary and were attributable entirely to dealings in the recipient's own shares and shares of its parent. There was also distortion as to the form of financial statements, such as when "combined statements" were issued which confused the investor by their similarity to "consolidated statements" which under the circumstances could not properly have been issued. In several instances form rather than substance was regarded in the preparation of consolidated statements, especially to excuse the exclusion from the statement of affiliated companies and to excuse the failure to eliminate certain of their transactions with parent companies, resulting in distortion of investment, income, and capital accounts. In instances, no mention was made of departures from advertised purposes and charter restrictions, violations of indenture provisions, market operations in their own securities, and those of affiliates, and transactions between "insiders" and the companies.

Considerable confusion was found in the accounting treatment of dividend distributions. Cash dividend payments, purporting to represent distributions of surplus earnings, were frequently nothing more than returns of stockholders' capital transformed into "dividends" through the twin devices of "paid-in" surplus and surplus created by a reduction of capital stock; while stock dividends in numerous instances were nothing more than stock split-ups.

Variations of accounting treatment also existed with respect to stock dividends received. While the largest number of investment companies entered stock dividends received at no valuation, others, in including dividend shares in income and surplus account and in portfolio account, used at least three bases of valuations, viz, at market value at time of receipt, at cash option price, and at pro rata amount charged to surplus by the issuing company. A fourth method was to sell the dividend shares upon receipt and enter the proceeds as earnings.

Although investment trusts have been relatively numerous since about 1925, so that their accounting problems have been forcefully before the industry and the profession for at least fifteen years, there

has not as yet appeared any comprehensive accounting discussion in the form of a manual or handbook. There have been a number of articles, most of which deal with special phases or with financial problems. None of them has attempted to present a well-developed accounting basis for the investment trust. There has been a general improvement in accounting methods for investment trusts during the past ten years, particularly since the enactment of the Securities Act of 1933 and the Securities Exchange Act of 1934. This improvement has worked toward a development of the standards of accounting principles applicable to investment trusts and has also worked toward a more adequate disclosure to stockholders and investors of the condition and the results of operation of these trusts.

Nevertheless, full disclosure alone is not the remedy which will remove the formidable handicaps which face the investor even today when studying published reports of investment trusts and investment companies. It is necessary that financial statements be produced which will enable a reasonably simple comparison of the statements of one company with those of another. The varying accounting methods which underlie the financial income and surplus statements being submitted to investors, make impossible such comparisons. Not only does one investment company utilize accounting methods diametrically opposed to those in use by another with respect to the computation of profits or losses upon the disposition of securities, but also in connection with the carrying value of securities which may vary as between original cost, market value, lower of cost or market, written-down value, values arbitrarily fixed in exchanges, and values taken over in mergers and consolidations. Due to write-downs by some companies and not by others, profits reported by one and losses by the other may represent equal rather than better and poorer performances. Unrealized profits and losses also are dependent upon carrying values. The unrealized depreciation by one company cannot be regarded unfavorably when compared to unrealized appreciation reported by another so long as carrying values of the two companies vary. Also involved is the varied treatment of stock dividends and rights received.

It is this handicap of fundamental differences in the methods of accounting revolving around the portfolio, the chief asset of investment companies, which needs to be overcome if so essential a requirement for investors as a comparable basis of financial statements of one investment company with those of others of the same class can be fully and successfully met.

Accountants' certificates which accompanied statements sent to stockholders were often characterized by equivocal phrases and material omissions. The statements themselves appear to have been more often inscrutable than informative. With respect to content they ranged from the merely inadequate by today's standards to the misleading, the greater number falling somewhere between the two extremes. The conclusion seems unavoidable that large numbers of stockholders were led to repose confidence in reports which would otherwise have aroused their suspicion, by the very presence in these reports of the names and certificates of certified public accountants. Although this may have resulted in some measure from the failure of the public to apprehend the limited nature of the accountants' engagement or from the fact that those limits were not made known, the

study discloses that even within the scope of their contractual duties the work of many accountants was replete with faults, both of omission and commission, which contributed materially to the end result. It is a commonplace, to which the present study gives point and substance, that protection which does not protect is more dangerous than none at all.

B. Accounting Practices and Procedures

1. COMPUTATION OF PROFITS OR LOSSES UPON SALES OF PORTFOLIO SECURITIES

a. Methods of Computing Profits or Losses

One of the major accounting problems in connection with investment companies is the method of computing the profits or losses on the sale of portfolio securities.

Generally the number of shares of a particular stock sold is less than the entire block of those shares held by the investment company. Usually the shares in the entire block have been acquired at different times and at different prices. As a result, a determination whether a profit or loss was realized, and the amount of such profit or loss, on the partial liquidation of the block may depend upon the method used to determine the cost of the particular shares sold. Several procedures have been used. It may be assumed, for instance, that the shares which were sold were those which were acquired first ("first in-first out" method). On the other hand, it may be regarded that the shares sold were the shares purchased last ("last in-first out" method). Another cost figure for the shares disposed of would be one arrived at by apportioning the cost of the entire block acquired equally upon all shares in the lot (the "average cost" method).[8] If the result desired cannot be obtained by the use of any of these cost bases, the management may choose particular certificates and identify these as the shares sold ("identified securities" method).

The New York Stock Exchange, discussing the various methods employed by investment companies to compute profits or losses on securities, indicated a preference for the average cost method:[9]

> The method of computation of trading gains or losses varies considerably as between companies. Where these gains and losses are both excluded from the income account, and where net realized trading gains are not held to be available

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[8] In this connection, in the *Financial Handbook,* second edition (1937), Robert H. Montgomery states at page 1250, as follows:

> PROFITS OR LOSSES ON SECURITY TRANSACTIONS. There are three principal methods of computing the profits or losses on securities sold:
> 1. *First-in, first-out.* This method of determining profits or losses shows an increased loss during a period of declining prices, and an inflated profit in a period of rising prices. A variation of this method—namely, last-in, first-out—would give an opposite result.
> 2. The *actual cost* of specific securities sold. This method permits certain abuses which are undesirable. Managers who desire to show favorable profits on security transactions may sell out the low-priced securities of a lot and leave those of higher cost in the portfolio. This practice might create financial difficulties for a company, especially in a period of declining prices.
> 3. The *average cost* of securities owned. This method has the approval of the New York Stock Exchange and gives a result which includes the favorable and unfavorable prices of securities still in the portfolio.

[9] "Statement on Investment Trusts, Committee on Stock List, New York Stock Exchange," adopted by the Governing Committee April 22, 1931.

for ordinary dividends, the method in which they are computed is of relatively less importance than in other cases. In cases where such realized trading gains appear in the income account and are regarded as available for distribution in the form of current dividends, the method of computing these figures assumes real importance.

Of the various methods of computation known to the Committee for the purpose of reporting, the method of computing costs of securities sold upon the basis of the average cost appears to be the only one which does not result in a distortion of the income account. Therefore, we urge upon all corporations who treat net realized trading gains as part of the income account and available for dividends to adopt that method.

The accounting firm of Haskins & Sells in their certificate accompanying the report to stockholders of Quarterly Income Shares, Inc. of October 15, 1933, indicated a preference for either the average cost, or the first-in, first-out method as against the method of identified cost of the actual securities sold adopted by the company. The views of both the management of this company (an open-end investment trust), and of the accountants are set forth in the certificate, as follows:

In computing profits and losses from sales of securities, as shown in the accompanying balance sheet, the company has employed as a cost basis (as set forth in its statements) the identified cost of the actual certificates sold. Such method, which has been approved for many years by the United States Treasury Department for Federal Income Tax purposes, permits the company, when sales are made, to identify as the shares sold those determined by the selection of the lowest cost certificate or the highest cost certificate or any certificate having a cost between the two, as it may elect. In our opinion the average cost method or the "first-in, first-out" method of determining costs for computation of profit is preferable from an accounting viewpoint to the method used by the company because the effect of the company's method may be less equable with respect to profits and losses and remaining asset costs than the other two methods. The management, however, maintains that in its business the identification method is preferable, as it permits through the selection of low cost certificates the sale of a lesser number of shares to accrue the same amount of realized profit than would be the case under either of the other methods and, therefore, permits a saving on transfer stamp taxes and on selling and buying commissions.

An indication of the substantial differences which may result from the use of one method as against another is contained in the accountants' certificate appended to the balance sheet and operating statement of the same company, Quarterly Income Shares, Inc., for the succeeding year, ended October 15, 1934. This certificate indicates that security profits would have been stated at $484,000 less than the $750,288 reported, and the portfolio value would have been shown at $537,000 less than the $27,498,904 as set forth in the balance sheet, if the average cost basis had been used in lieu of the identified cost basis as adopted by the management.

The Corporation has determined its net profit from sales of securities by identifying the cost of the certificates delivered, in accordance with its established practice, which practice is approved by the United States Treasury Department for Federal income tax purposes. In our opinion, the determination of profits and losses from sales of securities on the basis of the average-cost of the securities owned (which basis would have resulted in realized profits, and the cost

of investments owned at October 15, 1934, being stated at approximately $537,000.00 less on the accompanying balance sheet, and net profits from sales of securities for the year being stated at approximately $484,000.00 less on the accompanying statement) is preferable from an accounting viewpoint, although such method is not approved by the Treasury Department for Federal income tax purposes. The aggregate of the realized and unrealized profits and losses since date of incorporation would be the same under either method.

William H. Bell, of the accounting firm of Haskins & Sells, testified with respect to the various cost methods in use, as follows: [10]

Q. Do you have any ideas on what method of computing the profits on investments,—"first-in, first-out," or "identifying securities," and "average cost"—should be used, or along that line?

A. My own idea is that the identified cost of securities is subject to too much abuse, although it is permitted by the Tax Department, I mean, that is Treasury Department, for taxable purposes.[11]

I think that, either "first-in, and first-out" or "average cost" is preferable and, it seems to me of those two, "average cost" is better, but in any event, whichever of the three methods used, it ought to be disclosed.

I don't know that there should be any real prohibition of using an "identified cost of certificates" and I don't see how you could do it.

Have I answered that question?

Q. Yes. Of course. I think from your testimony that one would be warranted in coming to the conclusion that the profit-and-loss account, if there is an item of profits on the investment in securities, if any basis other than * * * cost is used, there should be a disclosure of that basis.

A. Yes; I agree to that. This is all constructive and for the future, and I think it is a good job you people are undertaking in that respect.

Table 36 indicates the several methods used for computing the profits or losses upon the sales of securities by the 62 closed-end and the 14 open-end investment companies reviewed. (Table on p. 1949.)

The lack of uniformity with respect to this salient accounting procedure reveals that not only did the methods vary as between investment companies, but variations existed as between periods for the same companies. It is also seen that four closed-end companies used more than one method during an accounting period. The majority used the average-cost method. Of the 62 closed-end companies studied, 30 consistently followed the average-cost practice, and 10 others adopted that method in later years.

b. Nondisclosure of Method of Computation in Reports to Stockholders

With the wide variance in results obtained depending upon the method of computation used, the necessity for disclosure to the shareholders of the particular method employed is apparent. Yet over one-half the companies studied (35 of 60 closed-end companies [12] and 8 of 14 open-end companies) failed, for the year 1935, to disclose

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[10] Public Examination, American International Corporation, at 6775–6.

[11] During the period under review, the identified-cost and the first-in, first-out methods were recognized by the United States Treasury Department for income-tax purposes, while the average cost method was not so recognized.

[12] Two of the 62 closed-end companies under review did not publish any reports.

in their reports to stockholders the method utilized by them to determine profit or loss upon the sales of securities. The record of such disclosure was even poorer in the earlier period. (See Table 37.)

A partial explanation for this lack of disclosure of method used may be that an implication exists, in the absence of disclosure of the specific methods employed, that the average-cost method was adopted. However, as long as a variety of methods are available, disclosure in every instance is necessary if clarity is to be had.

TABLE 36.—*Methods used for the computation of profits or losses upon sales of securities, 1927–35*

	Change in practice		Practice consistently maintained (number of companies)
	Year of change	Number of companies	
Closed-end companies:			
"Average cost or book value"[a] consistently			30
"First-in, first-out," consistently			10
"Identified cost or book value of specific security," consistently			4
"Identified cost" and "replacement cost" during same accounting period[b]			1
"First-in, first-out" and identified cost or book value of specific security during same accounting period			3
Changed from "first-in, first-out" to "average book value"	1930	5	
	1931	2	
	1935	1	
Changed from "identified cost" to "average book value"	1930	1	
	1932	1	
Changed from "first-in, first-out" to "identified cost"	1931	1	
Information not available from replies submitted			3
Total		11	51
Open-end companies:			
"Average cost," consistently			3
"First-in, first-out," consistently			4
"Identified cost of specific certificate," consistently			3
"First-in, first-out," with few exceptions where "identified cost of specific certificate" was used			3
"Identified cost of specific certificate" with few exceptions where "first-in, first-out" was used			1
Total			14

[a] For explanation of average cost or book value, see infra.

[b] In the accountants' certificates included in the reports to stockholders of British Type Investors, Inc., for the fiscal years ended Feb. 28, 1934 and 1935, it was stated: "In the case of securities sold and repurchased prior to the end of the year, profit and loss has been generally computed on the basis of replacement cost only."

(1) INTERSTATE EQUITIES CORPORATION

The methods heretofore discussed with respect to the determination of the cost of shares as the basis of computing and entering the profit or the loss dealt with the situation where the transaction was consummated and was closed on the books. However, a procedure was employed by some investment companies whereby the trade was not closed on the records, but rather was kept open by entering in invest-

ment account the amount of the proceeds of the sales without any adjustment to profit and loss account until the entire block of a particular security was sold. One effect of this practice is to add to the cost of the shares remaining in investment account if the net result of completed sales was a loss, or to diminish their cost if the net result of the sales was a profit, upon any accepted basis of cost. This procedure effectively covers up the results of the management's trading until all the shares in the lot are sold. If profits result in the interim before the lot is entirely disposed of, the profits constitute a hidden reserve. If losses ensue, this record is concealed from the stockholders, for the losses are capitalized as an additional cost of the shares remaining.

TABLE 37.—*Disclosure in reports to stockholders of method used for the computation of the reported amount of profit or loss from sales of securities, 1927–35*

	Change in practice		Practice consistently maintained (number of companies)
	Year of change	Number of companies	
Closed-end companies:			
Method disclosed, consistently			2
Method disclosed, beginning	1929	1	
	1930	5	
	1931	5	
	1932	5	
	1933	2	
	1934	5	
Method not disclosed, beginning	1930	1	
	1932	3	
Method not disclosed, consistently			31
Total		27	33
Open-end companies:			
Method disclosed, consistently			3
Method disclosed, beginning	1932	2	
	1934	1	
Method not disclosed, consistently			8
Total		3	11

Interstate Equities Corporation[13] in the period between July 29, 1929, and June 30, 1930, followed this practice. The procedure was described in the published report for that period as follows:

All profits or losses from the sale of securities in the investment portfolio have been left in this account as it is not the policy of your management to draw any earnings from this source until the investment portfolio has an ample reserve for market fluctuations.

In this instance the stockholders would have been unaware of net trading losses (aggregating $733,099) which occurred during the period if the accountants had not revealed this information in their certificate accompanying the balance sheet and statement of operations.

[13] This company was not included in the group of 62 closed-end companies analyzed.

The accountants, Price, Waterhouse & Co., arrived at this trading result after ascertaining the cost of shares sold upon the first-in, first-out basis. Edward R. Tinker, president of Interstate Equities Corporation, in a letter included in the published report, defended the company's practice and argued against the first-in, first-out method as follows:

Neither does the Management believe that the theoretical method of computing profits by applying the first sale to the first purchase is a proper one. In a declining market, the first purchases are usually the highest cost purchases, and therefore, when first sales are applied against same, they may show a loss, whereas in many instances the account may show an actual profit; in a rising market, the first purchases are usually the lowest cost purchases, and therefore, sales applied against same may show an exaggerated profit. This Corporation has adopted the method of accounting which, based upon the President's experience in other large financial institutions, has proven in his judgment the truest test of actual earning power.

Theoretical profits are disregarded—only actual profits appear in the earning statement, and theoretical "realized" profit and loss transactions are not considered as profit and loss. * * *

Mr. Tinker, when examined on his theories of profit or loss on portfolio transactions testified in essence that as long as there were any securities in the portfolio no loss was sustained on any completed sales, since, theoretically at least, the remaining securities could appreciate sufficiently to overcome the "realized" loss on the sales effected:[14]

Q. Now, frankly, Mr. Tinker, I didn't clearly comprehend your disagreement with me with respect to the statement I made about the shrinkage in the capital of the Interstate Equities Corporation between the period of July 28, 1929, and June 30, 1932.

Let me tell you what my difficulty is, and maybe you can help me. I look at your annual report to stockholders of June 30, 1930, and on the balance sheet, and I see, under the assets side, $27,599,780.55.

* * * * * * *

And I look at the report to stockholders for the period ending June 30, 1932, and I see in the balance sheet, under assets, $4,457,419—

* * * * * * *

Now, will you please, in your own way, explain the difference between those two figures? The $27,599,780.55, and $4,457,419.39.

What do you say represents that difference?

* * * * * * *

As I recall it, you stated that the reason you disagreed with my conclusion was that the securities were still on hand and that although that may have been the market value of those securities, had they been sold out against your orders, there would have been a capital appreciation which would have recouped the difference? Isn't that so?

A. Yes; and I also stated that if that same method would have been applied to all other financial institutions in the country, they would have been in serious trouble, and the whole country would have been in serious trouble; and that, therefore, this wasn't a fair conclusion to draw from that statement.

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[14] Public Examination, The Equity Corporation, at 342–5, 354–60.

Q. From that statement are we to infer, Mr. Tinker, that from June 28, 1929, to June 30, 1932, you had precisely, had you, at June 30, 1932, the same securities you had when you started in October?

A. We didn't have precisely the same, but we had about the same list. If we saw an opportunity to exchange, as we did in some securities, at a profit, we were doing it. We also sold securities at a loss at times. We were entering into transactions all the while.

Q. What I am trying to find out is when do you consider that a loss has accrued to the stockholders or to the trust?

A. An actual loss only accrues at the time the loss is determined. You can't determine theoretical loss in securities. You can make a statement and say that "This is based on the current value of the security today"; but you can't say that it is a loss.

* * * * * * *

Q. Now, you bought 100 shares at 100; you bought 100 shares at 99, and you bought 100 at 98. You know what the first-in, first-out theory is, don't you?

A. That is the tax theory.

Q. The first sale against the first purchase?

A. Yes.

Q. So that means, if you used that theory, then the first sale at 99 would be applicable against the first purchase at 100, and you would have lost one point on the security and you would have sustained a loss of 100. You didn't believe in that theory? You said so to the stockholders?

A. Yes, sir.

Q. Now, the other theory is to identify the securities they offer? Isn't that so? Where you sell at 99 you reserve to yourself the right to select which security you are going to deliver under that sale, and you have the right to select either the $98 one, the $99 one, or the $100 one?

A. That is the tax theory again.

Q. You didn't believe in that?

A. No.

Q. Now, the other alternative that I see is that you figure what the three hundred cost you, figure what the average price is for the block, and that is what the security cost you?

A. Yes.

Q. And that is the one you believe in?

A. No, that is the one that one of those fellows that fell down on the test—

Q. Well, which one? What other alternative is there?

* * * * * * *

A. I am telling you the theory at that time had been the theory on which I had operated the securities business for a great many years, the only one I found where I didn't fool myself by taking profits where they should not be taken. When the block is closed out, the whole 500 were sold, you could take the profit over. If the account reached the stage where the cost had been wiped out and there was still stock in it, of course you could take the profit. In order to get the true picture on the other side you had to set up your book value, the book value of your securities and what the market value was at the moment. If that book value was under the market value, you had no right to take any profit out of that security account, because your book value was under the market.

* * * * * * *

Q. Let me take a hypothetical case again, Mr. Tinker. Suppose you bought the 300 shares of stock and you sold the 300 shares out completely and didn't have a

single share of that stock. Would you be in a position to determine whether you had a profit or loss then?

A. Not if the security account as a whole was under water, as we term it. In other words, Judge, if those securities were at that present moment, that asset which you were trying to get a profit out of, that group of investments had depreciated so that there was a depreciated loss for the moment there, you could not withdraw from that and claim it as a profit. No matter what the accounting theory may be, you can't have a profit in that account if it is under water.

* * * * * * *

Q. Suppose your investment account had fifteen different stocks in it. One of them was United States Steel. You sold out all of your United States Steel at a loss. Would you count that a loss on your books?

A. We balance that off again in the securities account.

* * * * * * *

Q. Let me just ask you this, Mr. Tinker: Suppose you had $25,000,000 worth of securities that were sold at a price which represented a difference of $24,999,999, and you had one security that was worth $1; do you say that that corporation did not sustain a loss of $24,999,999?

A. It will show right here on the balance sheet.

Q. But I mean, you say that is not a loss because you have still got a security there which may appreciate to $24,999,999?

A. You took an extreme case.

Q. Isn't that so? Isn't it according to your theory?

A. You can carry these theories to absurdity.

(2) THE KIDDER PEABODY ACCEPTANCE CORPORATION

Another instance of this kind of practice was that of The Kidder Peabody Acceptance Corporation. The accountants in a report as of July 15, 1931, with respect to this company, stated:[15]

The item of net loss on sales of securities, amounting to $62,777.42 is based on book values which do not in every case represent cost. It has been the policy in earlier years to treat the proceeds of sales of a security as a reduction in book value and to make no adjustment of profits or losses until final disposition of the entire lot. In addition mark-ups or mark-downs of securities have been made from time to time.

As a result of this practice, the present book value of securities represents a composite figure, including the cost, the proceeds of sales, adjustments in valuation and various other items. A uniform procedure should be adopted whereby profits or losses on each sale would be transferred to the Profit and Loss Account.

(3) AMERICAN SUPERPOWER CORPORATION

The possibilities that exist for recording different results for the same transaction, and where the stockholders were not informed of the method used which was a far-reaching change in its regular practice, may be observed in the case of American Superpower Corporation.

In 1929, a resolution of its board of directors directed the disposal first of the higher-cost securities in the portfolio. Previously the customary method of computing cost had been on the first-in first-out basis. The corporation sold a block of 820,000 shares of stock of Commonwealth and Southern Corporation at $15 a share. By identifying

[15] Public Examination, Consolidated Investment Trust, Commission's Exhibit No. 3174.

the higher-cost shares as the stock sold, a loss of $3,250,000 was recorded. The remainder of the lot was sold in subsequent years at the same price of $15 per share, but since the higher-cost shares had been extracted previously from the lot, the later sales resulted in profits. By this procedure of carrying forward the lower-cost securities, profits were deferred. The 1929 published report, which was not accompanied by an accountant's certificate, was silent on the methods in use by the company for the computation of results from the sales of securities and consequently this accounting stratagem was concealed from the stockholders.

2. TREATMENT OF PROFITS AND LOSSES UPON THE SALE OF SECURITIES

Up to the end of 1930, most investment trusts and investment companies included profits and losses upon sales of portfolio securities as an element of income account—in other words, it was the practice not to treat trading results as an isolated part of surplus account, or one of its subdivisions.[16] Commencing in 1931, the procedure of reporting investment profits or losses as an item in income account was generally changed. The modification of the earlier practice was in no small measure attributable, no doubt, to the prolonged downward trend of the security markets. In the earlier period, the income account was comprised of investment profits to a large extent. In the later period trading results were, in the main, net losses of an amount which exceeded the ordinary interest and dividend income. The method used to avoid "red ink" or deficit results was to exclude these trading losses from the income account.

This avoidance of the diminution of income account by realized portfolio losses preserved the income account as the ostensible source for the payment of dividends by those companies with the policy of making cash distributions from current or accumulated net ordinary income, that is, from income derived from interest and dividends on portfolio, with deduction for operating expenses, but without deduction for losses on the sales of securities.

In published reports of several of the companies having such a dividend policy, the amount of realized losses was consistently deducted from the amount of the net ordinary income. If losses on portfolio transactions were excluded from income account and were deducted from net ordinary income, then profits, when they were realized, also were excluded from income account, and were added to net ordinary income.[17] Other investment companies never had the policy, in the period under review, of excluding trading results from income in determining surplus available for distribution. Accordingly, trading results, as a rule, in a number of these instances, were reported as an item of income account.[18]

[16] See Appendix K.

[17] Among such companies are Carriers and General Corporation, The Lehman Corporation, and Utility Equities Corporation, whose dividend policies are reviewed hereinafter. Their treatment of trading results is indicated in Appendix K.

[18] Examples of such companies whose dividend policies also are reviewed specially are American Capital Corporation, United States & Foreign Securities Corporation, United States & International Securities Corporation, and Mayflower Associates, Inc.

The elimination from income account of profits and losses from the sales of securities took the form upon numerous occasions of carrying these results directly to surplus account, either to capital surplus or to earned surplus, or to reserves allocated from earned or capital surplus.

In some cases, the trading results were carried directly to earned surplus account, in order to make them, together with other items, available for dividends.[19] In other cases, trading results were isolated in earned surplus accounts but they were not to be regarded as available for dividends.[20]

Another method of segregating investment profits and losses employed by investment companies was to accumulate these results in capital surplus account. Some companies posted investment profits and losses to capital surplus accounts and did not take into account profits and losses from the sales of securities in determining availability of accumulated earnings for dividend purposes.[21] However, other companies similarly carried realized profits and losses to capital surplus account, but the policy of these companies was to consider trading profits as available for dividend distributions.[22]

Thus, investment trusts and investment companies have treated profits and losses upon the sales of securities in a variety of manners: as an item of income, as an addition to or deduction from net ordinary income, as an element in earned surplus account, as a part of capital surplus account, and as a special surplus account.

Aside from the treatment of security profits and losses as it is affected by dividend policies, it has been urged that such profits and losses should be eliminated from income account as a matter of form. The New York Stock Exchange in 1931 stated: [23]

> The Committee favors the elimination from the Income Account of all profits or losses on security transactions and crediting or debiting them, preferably to a properly designated reserve, or else to a special surplus account which would be a segregated part of the Earned Surplus * * *. In cases where profit on sale of securities is treated as a part of the income, losses on sale of securities must be treated as part of the deductions from income. If reserves have been established against such losses, the full realized losses should first be included in the Income Account, and any utilization of such reserves should be treated thereafter as a transfer from reserves to the credit of Income Account.

In the same year the New York Stock Exchange again referred to this subject of portfolio profits and losses: [24]

> Such gains and losses are more closely related to the unrealized appreciation or depreciation of the portfolio than to the current dividend and interest income.

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[19] The dividend policy of American Cities Power and Light Corporation was as follows: "* * * all dividends paid in cash and Class B Stock prior to April 30, 1933, on the equity securities of the declarant were paid out of accumulated earnings, including profits from the sale of securities and stock dividend income credits. (Reply to Commission's questionnaire for American Cities Power and Light Corporation, Pt. V.)

[20] For 1935, Utility Equities Corporation posted investment profits and losses in earned surplus account, but the trading results were not taken into account when dividends were disbursed.

[21] For example, Niagara Share Corporation of Maryland.

[22] British Type Investors, Inc., The Broad Street Investing Co., Inc., Capital Administration Co., Ltd., and Phoenix Securities Corporation.

[23] New York Stock Exchange, Special Requirements for Listing Investment Trust Securities, approved by Committee on Stock List, June 6, 1929, as amended to April 1931.

[24] Statement on Investment Trusts (Management Type) April 22, 1931.

If this procedure is followed, Investment Trust reports will be more informative to investors, in that the income account will then clearly set forth merely the net result as between current income and current outgo, and this information, separated from security profits, is of particular value to holders of prior securities bearing a fixed rate of return. Furthermore, there would thus be eliminated any basis for the illusion that occasional profits realized on the sale of securities form a proper basis for measuring continuing earning power.

In May 1937, George O. May, of the accounting firm of Price, Waterhouse & Co., stated: [25]

A step which I should regard with satisfaction would be the general acceptance of the practice of excluding from the income account capital gains and losses realized otherwise than in the ordinary course of a company's business—indeed, I believe that even in the case of investment trusts, in which capital gains and losses might be said to be normal incidents of the business, it is preferable to exclude them from the ordinary income account.

As has been indicated, the general practice in the earlier period was to classify profits and losses upon the sale of securities as an item of income account. However, subsequently, when such trading results were no longer regarded as an element of income account, no general accord but rather confusion prevailed as to the treatment of this item by the investment trust industry. Whether realized profits are to be regarded as income, or as an addition to or deduction from net ordinary income, or as a surplus item of a capital or special nature, as distinguished from an earned surplus item, has been within the freely used discretion of the managements. The uses and purposes to which income account and the different surplus accounts are to be put have influenced the treatment of security profits and losses. The managements and accountants have not been restrained by any fixed or established accounting rule in this regard.

While it would appear that there was agreement that security gains and losses should be recorded in surplus account, or in a reserve account allocated from surplus, there was an existing difference of opinion as to which of the various surplus accounts should carry these results. Lybrand, Ross Bros. & Montgomery expressed the opinion that trading results should not be carried in capital surplus account but should be shown in earned surplus account.[26]

Whatever may have been the motives which dictated the change in practice of reflecting profits and losses upon sales of securities elsewhere than in income account—whether dividend policy, more conven-

[25] *Journal of Accountancy*, May 1937, p. 361.

[26] Reply to the Commission's questionnaire for The Reybarn Company, Inc., Pt. 1, Annual Report for year ended May 31, 1935.

To the Board of Directors of the Reybarn Company, Inc.:

We have examined the accounts of The Reybarn Company, Inc. for the year ended May 31, 1935, and subject to the charging of the net amount of profits or losses on sales and write-downs or write-offs of investments, etc., to profit and loss reserve, representing allocated capital surplus, rather than to earned surplus, we certify that, in our opinion, the above balance sheet and related capital surplus, earned surplus, and profit and loss reserve account set forth the position of the company at May 31, 1935 and the results of its operations for the year then ended before giving effect to the indicated shrinkage in investment valuation based on May 31, 1935 market quotations and appraisals by the Board of Directors below the amounts at which such investments are carried.

LYBRAND, ROSS BROS. & MONTGOMERY.

NEW YORK, *June 25, 1935.*

ient form or classification, or other compelling purposes—the fact is that an inconsistency in practice did exist in the period under review from 1927 to 1935. When realized profits were the prevailing results, these profits were usually included in and substantially increased the income account, but when these results were displaced by realized losses these losses were transferred to other accounts, thereby avoiding a diminution of the income account.

Where trading profits and losses were not handled in income account but in surplus and reserve accounts, and the stockholders were not furnished with a complete analysis of surplus and reserves, the method of including the trading results in surplus or reserve account proved to be a device which was employed upon occasions to keep stockholders in ignorance as to the extent of trading losses suffered.[27]

Appendix K, which presents the treatment of profits and losses upon sales of securities by specific companies, graphically reveals the disorder which existed with regard to the accounting handling of trading results of investment companies beginning in 1931 and continuing through 1935.

An illustration of successive changes in accounting for investment results was the treatment by The Adams Express Company:

1928 to 1930	Realized Net Profits in Income Account
1931 to 1933	Realized Net Losses in Earned Surplus
1934	Realized Net Profits in Earned Surplus
1935	Realized Net Losses in Capital Surplus

With the general abandonment of the practice of handling profits and losses on security transactions through income account, these trading results were treated in a variety of manners. The data for the year 1935 show the confusion which existed with respect to accounting practices relating to trading results. In 1935 of the 60 closed-end companies[28] reviewed, 17 (12 with profits, 5 with losses) continued to include trading results in income account; 9 showed investment results as an addition to or deduction from net ordinary income;[29] and the remaining 34 companies, or approximately 56% of the entire number, treated capital gains and losses in surplus or surplus reserve accounts, although there was no unanimity as to which of the several surplus accounts should reflect the results. Ten companies (eight with trading profits, and two with trading losses) used earned surplus account, or a similar account, like operating surplus, or undistributed profits account. Eleven other companies (eight with profits, and three with losses), however, treated trading results from a different viewpoint, and handled these results in the capital surplus account. One closed-end company carried certain of its 1935 results to capital surplus and another portion to income account, while three other companies with trading profits treated these results as an item apart from other surplus accounts, in accounts which were segregated or detached parts of surplus account. Three companies (one with a net investment loss, and two with investment profits) showed these results in surplus

[27] See "Reserves to Provide for Depreciation of Securities" and "Inclusion of Analyses of Surplus Account," infra.

[28] Two of the 62 investment companies included in the group reviewed were not in existence at the end of 1935.

[29] Five of these companies previously had included such trading results in the account.

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accounts which were of a mixed character, that is, surplus accounts which contained items usually present in both earned surplus and capital surplus accounts. The six remaining closed-end companies (two with profits, and four with losses) dealt with their trading profits and losses in reserve accounts. Of these six reserve accounts, two were appropriated from capital surplus accounts, one was set up from both earned and capital surplus, one was created from earlier net profits and from discounts upon its own debentures reacquired, and two reserves were set up from surplus accounts of a mixed character.

The following table summarizes the practices of 56 of the 62 closed-end companies trading in 1929, compared to the summary of the practices in 1935, just reviewed, of 60 of the 62 closed-end companies active in that year:[30]

Trading results reflected as follows in 1929	Companies reporting net trading profits	Companies reporting net trading losses	Total closed-end companies reviewed
In income account	38	6	44
As an addition to or deduction from net ordinary income	3	3	6
In earned surplus	1		1
Reflected finally in earned surplus	42	9	51
In capital or paid-in surplus	2		2
Combination of methods:			
In income and reserves	1		1
In income and capital surplus	1		1
In earned surplus and capital surplus reserve	1		1
Total	47	9	56

Trading results reflected as follows in 1935	Companies reporting net trading profits	Companies reporting net trading losses	Total closed-end companies reviewed
Included in income	12	5	17
As an addition to or deduction from net ordinary income	7	2	9
In earned surplus	8	2	10
Reflected finally in earned surplus	27	9	36
In capital surplus	8	3	11
In surplus accounts specially segregated	3		3
In surplus accounts of a mixed character	2	1	3
In capital surplus and income	1		1
In reserves:			
Allocated capital surplus	1	1	2
Allocated capital and earned surplus		1	1
Allocated from earlier net profits and from discounts upon reacquired debentures		1	1
Allocated from surplus accounts of a mixed character	1	1	2
Total	43	17	60

[30] Additional information with respect to the treatment of realized profits and losses is contained in the sections which follow dealing with write-downs of the carrying values of securities, carrying securities at each year-end at the lower of cost or market value, and the creation of reserves to provide for depreciation of securities. These discussions will emphasize the conglomeration of practices that exists in connection with the treatment of profits and losses upon the sales of securities by investment trusts and companies.

With reference to the 14 open-end companies reviewed, the following table recapitulates their practices in 1935:[31]

Trading results reflected as follows in 1935	Number of open-end companies
Income	2
Addition to or deduction from net ordinary income	1
Earned surplus (or accounts under earned surplus)	6
Reflected finally in earned surplus	9
Capital surplus (or paid-in surplus)	2
Statement of principal	1
Surplus account, specially segregated	2
Total	14

3. WRITE-DOWNS OF CARRYING VALUES OF SECURITIES[32]

A write-down usually represents the reduction of the value of an investment from cost or other carrying value down to the market or the fair value as at a designated date. During the period under review, there were only a few write-downs in 1929 and 1930 by the companies studied, but there were a number of write-downs in each of the years 1931 to 1935, with the largest number of instances occurring in 1931. Typical of the explanations submitted as justification for write-downs was that expressed in 1931 by the accounting firm of Lybrand, Ross Bros. & Montgomery, viz:[33]

> * * * Securities had been acquired during an era of high prices. These prices have materially fallen. It cannot be predicted, even for some years ahead, whether a period of such high prices will again prevail. Therefore, the stockholders decided to recognize their losses and to start anew on the basis of the lower price levels of today * * *

Generally, just prior to the effective date of the write-down, the capital stock of the company was reduced in an amount sufficient to create a capital surplus account, which, together with earned surplus, except in cases cited later, absorbed the amount of the write-down. Thus, write-downs occurred, as a rule, although there were exceptions, in connection with readjustments of the capital structures of investment companies.

Of the 62 closed-end companies reviewed, 17 companies participated in write-downs of the kind discussed, some companies upon two and others upon three different occasions.[34] Five other companies marked down the value of their investments to the lower of cost or market

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[31] One company which showed trading results in capital surplus sustained a net trading loss for 1935. The remaining 13 companies reported net trading profits.

[32] Exclusive of write-downs arising from carrying securities at each year-end at the lower of cost or market value.

[33] Letter dated May 11, 1931, to Oil Shares, Inc., which letter is reproduced in full hereinafter in this section.

[34] See Appendix L, Schedule 1.

values, or to the lower of book and market values, at the end of each fiscal year over a period of years.[35]

Of the 17 closed-end companies examined, the majority charged the write-downs first to any existing earned surplus until exhausted, and then charged the balance to capital surplus or allocated capital surplus. It was also the rule to designate, in published reports, earned surplus account as arising since the date of the write-down, which date was usually the same as the date of the recapitalization. The reduction of capital stock accounts, and its attendant newly-created capital surplus account, enabled the companies to free themselves from any deficit in their surplus accounts. These procedures, including the exhaustion of earned surplus accounts, established the companies upon the same footing as if they had carried through plans of reorganizations without organizing new corporate entities.

However, 8 of the 17 companies reviewed did not charge off any part of the write-down against existing earned surplus, while in 2 companies only a portion of earned surplus was so utilized. This failure to exhaust the entire earned surplus account did not conform to the general practice, equivalent to a reorganization, of conducting the future operations of the company with a "clean slate."[36]

With respect to the treatment of investment profits and losses, a new basis was created for the computation of profit or loss upon the subsequent sale of portfolio securities which may have comprised shares written-down in value and shares acquired after the date of the write-down. This new basis is often referred to as the "average book value," or as the "adjusted book value," which values represented the written-down amount plus the cost of subsequent acquisitions. Where the sales exceeded this average book value, a profit was recorded, although upon the original cost basis the result actually may have been a loss. Where the sales proceeds were less than the average

[35] These instances are reviewed separately hereinafter. Also discussed in a following section is the method of allocating some part or all of the unrealized depreciation of securities to reserves. A single instance where, under special circumstances, securities were written down to their liquidating values, is not included in this discussion. Also not included are write-downs of specific securities, of participations in syndicate and joint accounts, and write-downs in connection with mergers and reorganizations.

[36] The Commission has recently stated its position with regard to accounting reorganizations as follows (*In the Matter of Associated Gas and Electric Corporation*, Holding Company Act Release No. 1873, dated January 10, 1940):

> An accounting reorganization permits a corporation to begin anew the accumulation of earned surplus. It, therefore, enables a company to pay dividends, even though the total operations of the enterprise have resulted in an earned surplus deficit, such dividends ostensibly being paid out of earnings rather than contributed capital. It can be justified only if it accomplishes with respect to the accounts substantially what might be accomplished in a reorganization by legal proceedings, namely, the restatement of assets in terms of present conditions, corresponding modification of capital and capital surplus, and commencement of a new earned surplus account as of the date of the reorganization. In short, the enterprise must be put on substantially the same accounting basis as a new enterprise. And because the primary excuse for the device is that it accomplishes expeditiously what might otherwise have to be accomplished by legal proceedings, clear disclosure of the transactions should be made, and appropriate consents should be secured.

Also, in this connection, see the Commission's Accounting Series Release No. 15, dated March 16, 1940, which, in part, states:

> Furthermore, in view of the importance of such proceedings [quasi-reorganizations], I [William W. Werntz, Chief Accountant] am of the opinion that until such time as the results of operations of the company on the new basis are available for an appropriate period of years (at least three) any statement or showing of earned surplus should, in order to provide additional disclosure of the occurrence and the significance of the quasi-reorganization, indicate the total amount of the deficit and any charges that were made to capital surplus in the course of the quasi-reorganization which would otherwise have been required to be made against income or earned surplus.

book value, a loss was recorded, but of course this loss was less, by the sum of the write-down, than the full loss measured on the basis of original cost.

Up to 1935, it was the general rule, in published reports, to carry trading results upon the new basis to earned surplus account either indirectly through income, or by way of an addition to or deduction from net ordinary income; or directly to earned surplus, or to a similar account such as operating surplus and undistributed profits accounts, or to allocated earned surplus reserves. Some companies carried the results to capital surplus, or to allocated capital surplus reserves, while others reflected these results in surplus accounts where there was no segregation of capital surplus items from earned surplus amounts. Two companies posted trading results to such distinct categories as special surplus and profit and loss on realization of investments.[37]

The significance of the practice of reflecting trading results in income account, or as an addition to or deduction from net ordinary income, or of carrying the results to earned surplus, or to capital surplus accounts, or to any of the segregated parts of earned or capital surplus, was discussed in the preceding section. However, since both earned surplus and capital surplus accounts are involved, as explained, in the absorption of write-downs, the treatment of trading results after a write-down raised new issues. These issues, as well as the treatment of write-downs, are discussed in the following letter of May 1931, by the accounting firm of Lybrand, Ross Bros. & Montgomery, to Oil Shares, Inc.:[38]

LYBRAND, ROSS BROS. & MONTGOMERY,
90 Broad Street, New York, May 11, 1931

Re: Oil Shares Incorporated.
Messrs. LEWIS, CARVIN & KELSEY,
120 Broadway, New York, New York.

DEAR SIRS: As requested by you we have given consideration to the accounting treatment to be given to an unrealized loss approximating $3,500,000 on securities in the portfolio of Oil Shares, Incorporated, under the circumstances recited below.

Oil Shares, Incorporated, was organized under the laws of the State of Maryland with 6 percent cumulative preferred stock of a par value of $50 per share and common stock without par value. The stock has been sold in units of preferred and common and on December 31, 1930, there were 89,226 shares of each

During April 1931 the certificate of incorporation was amended and the
During April 1931 the certificate of incorporation was amended and the
issued capital stock reduced by $3,362,814. The preferred stock was changed from a par value to a no par value stock and its declared value stated at $20 per share. The declared value of the common stock was reduced from $10 to $1 per share.

On the basis of present market values there is stated to be a shrinkage of approximately $3,500,000 in the corporation's investment, which shrinkage it is intended should be given effect on the books.

There would seem to be two possible methods of accounting for this write down of security values. One is to charge the write down first against the

[37] See Appendix L, Schedule 2.

[38] Public Examination, Oils & Industries, Inc. (formerly Oil Shares, Inc.), Commission's Exhibit No. 1527.

existing earned surplus of something less than $100,000 and to charge the balance against capital surplus which will largely have arisen through the capital readjustment above mentioned. The second possible treatment would be to leave the present earned surplus intact and apply the whole amount of the shrinkage to the capital surplus.

There are undoubtedly arguments in favor of the first method because it may rightly be said that the existing earned surplus arises mainly from realized gains from sales of securities during the past few years. Since the shrinkage in value occurred mostly in prior years, or we assume that to be the case, it would seem logical that such shrinkage should be applied to offset the realized gains from sales of securities. However, if that were done, there would seem to be an intention to ignore the recapitalization and to continue accounting on the basis of former capital values. It might be inferred that in following out the same theory for the future the income account, and, consequently, earned surplus, should be credited with gains from security sales only to the extent that original cost rather than written down value has been exceeded. The effect would then be that capital surplus would ultimately be restored to its full amount before applying any part of the write down of security values.

We believe that the pursuit of any such theory would lead to accounting complications and would not reflect the intention of the recapitalization as well as the second method. For example, if a stock had been bought in 1929, at, say $100, its market value at April 1931 was $50, and it was eventually sold for $70, the accounting treatment in pursuance of the theory mentioned would be to write off $50 at this time and at the time of sale to credit capital surplus with $50 and charge earned surplus with $30.

In a pamphlet issued by the New York Stock Exchange, dated April 30, 1930, with reference to stock dividends, the following comment appears:

> "As recognition of the importance of earnings in the evaluation of securities tends to be emphasized, the importance of an accurate segregated statement of Earned Surplus in the Balance Sheet does so likewise. Accounting should be adapted to the end that this account should show at any given time the exact amount of realized undistributed earnings, either from date of organization, or in the event of recapitalization, from some fixed stated date."

This statement suggests there is nothing objectionable in the first method because the earned surplus would show merely the amount of *realized* undistributed earnings. However, from a practical standpoint, we favor the second method.

Under the second method, the effect of the reorganization is shown in the same way as if a new corporation had been formed. That is to say, a fresh start would be made with no earned surplus but with a stated capital, together with a capital surplus representing the excess market values of assets over the stated values of the capital stock. This would seem to express the thought underlying the capital readjustment. Securities had been acquired during an era of high prices. These prices have materially fallen. It cannot be predicted, even for some years ahead, whether a period of such high prices will again prevail. Therefore, the stockholders decided to recognize their losses and to start anew on the basis of the lower price levels of today. It would reasonably follow that the profits of the past would be absorbed in the process of recognizing this shrinkage in values.

We feel that if the present earned surplus is eliminated in this manner and the securities written down to their present market value, future profits may be

properly based upon such written down values. In the illustration cited above the sale of $70 would result in a profit and hence an earned surplus of $20. There would then be no occasion to make any restoration of capital surplus with its attendant complications.

Very truly yours,

(Signed) LYBRAND, ROSS BROS. & MONTGOMERY.

The methods of the treatment of write-downs and trading results after write-downs advocated in this letter were generally used. Several exceptions, however, will be noted.[39] In each of 17 instances of write-downs, capital stock account was reduced to provide additional surplus for the absorption of the write-downs as one, if not its main purpose.[40]

Where write-downs have occurred complete disclosure that the published trading results are computed on a basis of adjusted book values representing written-down amounts and cost of subsequent acquisitions, is essential. Without such a full disclosure, published "realized profits" of the kind described might easily be mistaken for actual profits—that the proceeds of the sale exceed the actual costs—when as a matter of fact the proceeds may be less than the original cost and therefore represent trading losses. For example, if a stock had been bought at $100 a share, was later written-down to its market value of $50, and thereafter was sold at $70, the rule was to report a $20 profit. If the accounting method upon which that profit was based was not specifically revealed, it might be assumed that the published profit was the usual one representing proceeds of $20 in excess of actual cost, when upon the basis of original cost the result was a loss of $30. If the selling price were $45, a loss of only $5 would be recorded, instead of an actual loss of $55.

Thus the publication of the results of trading operations occurring after write-downs without adequate disclosure of the accounting methods employed may be highly misleading. Various instances of this failure to indicate specifically that the published profits and losses upon the sales of securities were based upon adjusted book values and not upon original costs existing.[41]

The write-downs by these companies brought the "book values" of securities down to a low level, and any improvement of this lower level of values permitted the companies to publish "profits." If, after the write-down, the downward trend continued, and the securities written-down were disposed of, the loss recorded and published was diminished by the amount of the write-down. However, in the same period there were investment companies which reduced capital stock account, thereby creating additional capital surplus, but these companies did not write down the values of the securities acquired during a high-

[39] See Appendix L, Schedules 1 and 2.

[40] Appendix L, Schedule 2, presents also the record of cash dividends distributed by the 17 companies after reductions of capital stock account and after write-downs. When the topic under discussion is read in connection with the following sections dealing further, in part, with reductions of capital stock accounts, other types of write-downs, and sources of dividend payments, it will be found that there is a connection between (a) the reduction of capital stock and the concurrent creation of additional capital surplus, (b) the write-downs of the value of securities, and (c) the dividends subsequently disbursed. The effect of the write-down and of its absorption chiefly by capital surplus account prevents a deficit from arising in the future which might be a cause for nonpayment of dividends.

[41] See Appendix L, Schedule 2.

price era. Accordingly, the original high-cost basis carried on the books was not disturbed. Upon disposition of these securities during periods of depressed prices substantial amounts of losses were recorded and published. For example, in 1931, The Lehman Corporation, as a result of a reduction of capital stock account, increased its capital surplus account by the sum of $37,759,500. However, the portfolio values of securities which were carried at cost were not changed. As a consequence, when, in 1931, 1932, and 1933, losses of $9,293,284, $19,172,554, and $1,316,685, respectively (or an aggregate of $29,782,523), were realized, these large losses were recorded and published. Resort was not had to the technique of writing-down the cost values of portfolio securities before their disposition so as to permit the company to record profits, or smaller losses, for the purposes of publication to the stockholders.

Similarly, Carriers and General Corporation, in 1930, 1931, and 1932, increased its capital surplus account by an amount of $8,163,604 through successive reductions of capital stock account. The cost values of securities, however, were not reduced, and in each of the years 1930 to and including 1935, realized losses were published, aggregating $8,778,087.

A graphic illustration of the differences between reporting trading results upon a basis of adjusted book values and upon a basis of original costs is furnished by the published reports of Phoenix Securities Corporation which reported these results by both methods.[42] For 1934, for example, upon a basis of original cost, the loss was approximately $1,000,000, while the amount accounted for in the income statement, on an adjusted book-value basis, was the negligible loss of $4,787.

Thus, although two investment companies may have sustained the same approximate realized losses in the same period of operations, one company which carries its portfolio on a written-down basis, is able to publish in the statement of profits and losses upon the sales of securities, or its equivalent, an item of realized profits or an item of insignificantly small realized losses, while the other company, which is on an original cost basis, must publish an item of a substantial amount of realized losses.[43]

4. CARRYING SECURITIES AT EACH YEAR-END AT THE LOWER OF COST OR MARKET VALUE OR THE LOWER OF BOOK OR MARKET VALUE

Only a few of the closed-end investment companies reviewed adjusted portfolio security values at each year-end regularly to the lower of cost or market values, or to the lower of book or market values.[44]

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[42] Profits and losses based on original cost were shown parenthetically. The accounting methods of this company with relation to this procedure are reviewed in the following section.

[43] The possible misrepresentation of the extent of profits or losses upon the sales of securities which were carried on a written-down basis was avoided by some companies by reflecting the amount of unrealized depreciation of securities in a reserve account to which are charged the realized losses. In this manner, realized losses are accounted for on an original cost basis, while at the same time, the unrealized loss as at a given date is fully or partially reflected on the record by the reserve allocated from surplus account. This method is reviewed and discussed infra.

[44] Only five of the 62 closed-end investment companies reviewed followed this practice.

This method reflected upon the books the net amount of unrealized depreciation existing at the end of each year. In adjusting portfolio values at succeeding year-ends, an additional mark-down was made for a further fall in value, while a mark-up was recorded for an improvement in value over the preceding period. Accordingly, upon a disposition of a block of securities, the sales proceeds were measured against their market value, if it was less than cost, at the close of the preceding fiscal period, plus, of course, cost of subsequent acquisitions. Thus, with respect to securities sold which were on hand at the preceding year-end, the amount published as a profit represented merely the rise, and a loss represented the fall, in market value since the end of the last fiscal period. As has been indicated in the section relating to write-downs, the published profits may in fact have been large trading losses, and the published losses may have been much less than the actual losses measured upon a basis of original cost of the securities sold. This situation was especially significant when there were successive mark-downs. This defect in the published profit and loss accounts where the portfolio securities were carried at the lower of cost or market values, could be overcome by publishing the trading results on the basis of original costs as well as on the basis of adjusted book values. However, although five companies carried portfolios at the lower of cost or market, in only one instance was such full and complete disclosure made.[45] The trading results on an original cost basis were not available in the cases of the remaining four companies. As to two of these trusts, the amount of realized profits and losses was published without the essential disclosure that the results were based upon adjusted book values.[46]

Adjustments of portfolio values were recorded by two companies in capital surplus account, by one company in an account equivalent to an earned surplus account, and by the remaining two companies in a mixed surplus account which was the only surplus account maintained on the books.[47] Realized results were generally reflected by all the five companies in the same surplus accounts in which the unrealized depreciation was reflected.

If these procedures be compared with the accounting methods relating to write-downs and trading results previously reviewed, it will be seen that a write-down was one item in a general plan of internal reorganization involving capital structure. It was the rule of the majority, but not of a minority, of those companies to exhaust earned surplus first in absorbing the amount of the write-down, while the much larger part of the write-down not absorbed by earned surplus was charged off to capital surplus account which was enlarged for that purpose through the reduction of capital stock account. Trading results were reflected as a rule in earned surplus account, although capital surplus had absorbed the largest part of the write-down. In these five instances where write-downs occurred in connection with

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[45] Phoenix Securities Corporation published its trading results computed on both these bases. For 1934, a loss of $992,013 was shown upon the original-cost basis, although the loss on an adjusted book basis was shown to be only $4,787. See infra.

[46] Had the reserve method hereinafter explained been used, trading results would have been furnished on original-cost basis, besides reflecting unrealized depreciation on the books.

[47] A more detailed discussion of the methods of each of these companies is contained infra.

the policy of carrying portfolios at the lower of cost or market, the amount of the write-down was not absorbed as to a small part by earned surplus and as to a large part by capital surplus. Contrary to the rule above, the amount was absorbed by one or the other of the surplus accounts.[48] Also, the trading results were carried to the surplus account which reflected the adjustment of the value of the portfolio, in one case in capital surplus account, while in two other instances in earned surplus account. In the remaining two cases, this point was not involved, since only one surplus account appeared on the books.

In three of the cases cited, there were reductions of capital stock account to augment surplus account. In one instance, the augmented surplus account assumed no part of the write-downs and reflected no part of the results from trading. In the other two cases, the amount of the surplus arising from reduction of capital stock, together with the amounts of write-downs resulting from carrying securities at the lower of cost or market and the amounts of profits and losses from the sales of securities, appeared in the same surplus account. In one case, the company, during the period under review, carried its portfolio upon three different bases: (a) at original cost, (b) at the lower of cost or market, and (c) upon the written-down basis discussed previously.[49]

a. Liberty Share Corporation

The investments of Liberty Share Corporation were carried, at the end of each calendar year, from 1929 to 1935, at cost or market, whichever was lower. This policy required mark-downs of the portfolio as follows:

1929	$2,790,481	1933	$181,438
1930	2,240,769	1934	70,195
1931	2,211,346	1935	161,114
1932	152,239		

These write-downs were made through surplus account, as distinguished from paid-in surplus existing on its books. In the paid-in surplus account, among other credits, there were credits arising from reduction of capital stock account, in 1931 of $3,978,336, and in 1935 of $823,557. The net profits (or losses) on investments sold were reflected in surplus account, via income account, as follows:

1930	$496,520	1933	$120,908
1931	(107,442)	1934	96,154
1932	150,866	1935	171,887

This company in 1931 and 1933 published no reports, and in the other years in the period from 1929, the year of organization, until 1934, the reports to stockholders contained a form of balance sheet but no income statements. The published balance sheet for the 1930 year-end contained figures which varied materially from those on the books.[50]

From 1929 through 1934, the shareholders received no information with respect to the company's income as affected by mark-downs result-

[48] This, of course, was not true as to the two cases where only one surplus account was kept on the records.

[49] Prudential Investors, Inc.

[50] This misleading aspect of the published report is discussed infra.

ing from the policy of carrying the portfolio at the lower of cost or market. In the 1935 published report, the company included an income account for the first time. This 1935 published income account was entitled "Statement of Profit and Loss and Surplus." The trading results were set forth in this statement in income without disclosure that the results were not measured on the basis of original cost. The amount of the write-down appeared as a deduction from net income. While the published report indicated that securities were carried at book values which were lower than market values, and indicated the amount of the write-down adjustment—disclosures which would provide clues that the trading results were upon an adjusted book-value basis—nevertheless a stockholder might be unaware that the investment profits and losses were not based on original costs without a specific statement of the basis.

b. Bankers Securities Corporation

The portfolio of Bankers Securities Corporation was carried, at the end of each of the years 1929 to 1935, at the lower of cost or market values, resulting in the following write-downs:

1929	$2, 754, 835	1933	$453, 053
1930	4, 222, 382	1934	151, 423
1931	3, 009, 821	1935	26, 717
1932	660, 769		

The mark-downs were reflected in profit-and-loss accounts which carried via income account the net profits on securities sold. These net profits, computed on the adjusted book-value basis, were as follows:

1930	$1, 622, 571	1933	$313, 282
1931	100, 569	1934	252, 899
1932	216, 448	1935	278, 277

Apparently no income account was published until that for the year ended December 31, 1933. In that year and in the subsequent published accounts for 1934 and 1935, these trading results were reflected in income, which was included in the statement of profit and loss. While securities were shown in the published reports at the lower of cost or market value, and the amount of write-down was disclosed as a deduction from net profit, no specific mention was made of the fact, as was the general rule, that the trading results were based on adjusted book values and not on original costs.[51]

c. Electric Power Associates, Inc.

Electric Power Associates, Inc., beginning with the year ending December 31, 1930, adjusted its portfolio values at each year-end to the lower of book value or market value. To reduce the securities owned to this basis, the portfolio valuations were reduced by the following amounts:

1930	$9, 972, 973	1933	$821, 946
1931	7, 424, 618	1934	36, 445
1932	4, 030, 447	1935	40, 060

[51] Bankers Securities Corporation did not reduce capital stock account in connection with write-downs of portfolio values during the period under review.

These appropriations were made from capital surplus which, in addition to other credits, included credits in 1930 of $10,000,000 and in 1931 of $9,200,000 arising from reductions in capital stock account. No part of these write-downs was appropriated from the existing earned surplus account, to which account dividends were charged. In 1931 the trading results, on an adjusted book value basis, were reflected in earned surplus account by way of income account, but thereafter security profits and losses were reflected in capital surplus account. These trading profits (and losses) were as follows:

1931	$187,945
1932	2,689
1933	(16,793)
1934	32,338
1935	77,219

d. Phoenix Securities Corporation

At the fiscal year ends August 31, 1930 and 1931, the investments of Phoenix Securities Corporation were carried at cost or market values, whichever were lower. Thereafter in 1932, 1933, and 1934 this policy was shifted to carry portfolio values at market, which values may have been under or in excess of cost values. In the main, however, the carrying values were below cost in these years. In 1935 the portfolio was carried at cost of $5,080,675, as compared to a market value of $5,524,431.

The adjustments ensuing from these practices took place in surplus account, which adjustments comprised mark-downs and mark-ups as follows:

1930. Mark-down		$1,607,282
1931. Mark-down		2,670,369
1932. Mark-down		1,622,732
1933. Mark-up:		
Excess of aggregate market quotations of securities owned on August 31, 1933, over the aggregate market quotations of the same securities on August 31, 1932, plus cost of securities purchased subsequent thereto, represented by—		
Appreciation of market quotations over cost	$233,532	
Excess (net) over August 31, 1932, market quotations but not in excess of cost	665,863	
		899,395
1934. Reduction of securities owned at August 31, 1934, to market quotations at that date	37,691	
Less—Appreciation of securities owned at August 31, 1934 (excess of market quotations over cost)	8,745	
		28,946
1935. Restoring to capital surplus the recovery of securities owned to original cost, which in the aggregate was less than quoted market value at August 31, 1935		1,914,254

In 1931, there was a reduction of capital-stock account in the amount of $7,511,500, and in 1932 to the extent of $1,737,390, which amounts were credited to the surplus account against which were charged the above mark-downs in portfolio securities.

The trading results, which were computed on the adjusted book values, that is, on the basis of the balance-sheet valuation at the beginning of the year plus cost of purchases, also were reflected in surplus account, via income and profit and loss account. In the published reports, to 1934, these trading results, together with the adjustments of portfolio values, were shown in the "statement of capital surplus (and income)," and in 1935 in "statement of capital surplus." In these published reports, this company not only published the investment profit and losses on the basis of adjusted book values, but also on a basis of original costs. These results were as follows:

Year	Published profits or (losses) based on adjusted book values	Published profits or (losses) based on original costs (shown parenthetically)
1931	($262, 686)	($478, 546)
1932	(631, 137)	(1, 225, 858)
1933	47, 244	35, 297
1934	(4, 787)	(992, 013)
1935	20, 382	(77, 083)

e. Prudential Investors, Inc.

Prudential Investors, Inc., organized early in 1929, maintained the policy of carrying investments at the lower of cost or market, or the lower of book value or market, only in the three-year period 1930 to 1932. At the end of 1930, its portfolio was marked-down to market, which was lower than cost by the sum of $6,899,383. This sum was charged to capital surplus which was composed solely of a credit of $12,750,000, representing the portion allocated from cash received in 1929 from the sale of capital stock. Against this sum were charged also the mark-downs to the lower of book or market values for 1931 and 1932, amounting, respectively, to $4,396,852 and $511,964. Subsequent to December 31, 1930, profits and losses on sales of investments were credited or charged to capital surplus. The losses were $57,224 in 1931, and $100,688 in 1932, which sums represented the excess of book values of securities sold over sales prices. In 1933, 1934, and 1935, the trading results were profits, respectively, of $327,802, $444,759, and $1,394,670, which represented the excess of sales prices over book values. The book value of the securities sold was based on the average book value of the securities held at the time of the sale. In this computation, a factor was the book value of the securities on December 31, 1932, which was the lower of book or market value.

Since the policy of lowering the value of securities to book or market, whichever was lower, was discontinued after December 31, 1932, the practice of this company as it pertained to portfolio operations

for 1933, 1934, and 1935 was similar to that of a company which wrote down its portfolio as at a certain date, these fixed values serving as a basis for the successive fiscal periods.[52]

This company employed three different accounting practices for the computation of security profits and losses. In 1929, the basis was original cost, while from 1930 to 1932 the basis was the lower of book or market, and thereafter the basis was the valuation set on December 31, 1932.

5. RESERVES TO PROVIDE FOR DEPRECIATION OF SECURITIES

Of the 62 closed-end companies reviewed, 25 created reserves at one time or another to provide for depreciation of securities. Of the 14 open-end companies, two created such reserves.

Reserves for depreciation are employed to reflect upon the record some part, if not all, of the unrealized depreciation of securities, while preserving original cost values as a basis for the computation of profits and losses when the securities are sold.

As has been indicated, when unrealized depreciation was reflected on the books by the method of writing down the value of the securities to their current market or fair value, this value, and not original cost value, became the basis for the computation of results when the securities written down were sold. Since some companies wrote down security values while others did not, different standards existed among investment companies with respect to reporting profits and losses upon sales of securities: (a) companies which reported profits and losses upon the basis of a written-down or adjusted book value; and (b) those companies which reported on the basis of original cost. Some closed-end companies wrote down values of securities as at a given date, and some wrote down securities at each year-end to the lower of cost or market. About one-third of the number of closed-end companies reviewed reported trading results upon the basis of such adjusted book values. Under this method, profits reported might, in fact, have been large trading losses, while the losses sustained may actually have been substantially larger than the reported amounts.

With respect to the companies which reported trading results upon the basis of original costs, 25 companies reflected an amount of unrealized depreciation in a reserve account. Several accounting abuses existed in connection with these reserve accounts, viz, failure to disclose the details relating to these reserves and the utilization of these reserves as a depository for losses realized during a fiscal period, while bolstering income account with profits realized in the same fiscal period without anything being said about it.

The following tabulation indicates the years during which depreciation reserves were established by the 25 of the 62 closed-end companies under review:

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[52] This practice has been reviewed supra.

Portfolio reserves created by closed-end companies	Number of companies	Portfolio reserves created by closed-end companies	Number of companies
Prior to 1927	1	During 1933	1
During 1929	6	During 1934	2
During 1930	6		
During 1931	8	Total	25
During 1932	1		

Reserves generally were appropriated from capital surplus, earned surplus, or both. For instance, American Superpower Corporation established as at June 11, 1934, a reserve for depreciation amounting to $65,000,000. Of this amount, $37,352,552.49 was charged to capital surplus, which exhausted that account, and the balance of $27,647,447.51 was charged to earned surplus. The following discussion of the nature and handling of reserve accounts by several investment companies will indicate the sources of the items composing the reserve accounts.

Of the 14 open-end companies studied, two—State Street Investment Corporation and Incorporated Investors—established depreciation reserves. These two companies handled reserve account differently as explained below.

a. State Street Investment Corporation

The report of State Street Investment Corporation covering the first quarter of 1932 stated that "On February 19, 1932, in order to permit a continuance of the dividend, it was voted to transfer $10,000,000 from capital to surplus and from this surplus to set up a reserve amounting to the difference between the cost and market value of securities as of December 31, 1931."

The balance in surplus account at December 31, 1931, was $979,990, but at that time the unrealized depreciation upon securities on hand amounted to $7,186,474. The amount appropriated from surplus on February 19, 1932, the same date as the reduction of $10,000,000 in capital stock account, was $7,186,474. During 1932, the amount of $3,780,203, and during 1933, the total of $1,173,671, representing realized losses on securities which were in the portfolio on December 31, 1931, were charged to this reserve. At January 1, 1934, the balance in reserve account amounted to $2,232,124. This balance, as at January 1, 1934, was restored to surplus by vote of directors on March 29, 1934.

In the balance sheets and statements of surplus for the period from date of organization through 1935 included in the questionnaire reply,[53] this reserve is combined with surplus, which is subdivided into earned and capital surplus, and the charges against the reserve are shown as charges to earned surplus.

[53] Reply to the Commission's questionnaire for State Street Investment Corporation, Part 11.

Thus, it is seen that during the existence of the reserve account, realized losses were carried to this reserve, which had the character of an account allocated from capital surplus, but after cancelation of the reserve the same realized losses are treated as earned surplus items.[54]

b. Incorporated Investors

Incorporated Investors, after substantially reducing the amounts in capital stock, created reserves from surplus to adjust the values of investments in the portfolio at December 31, 1930, 1931, 1932, and 1933, from cost, to cost or market, whichever was lower. The amounts of these reserves were deducted from the cost value of the investments.[55] Since these reserves were utilized solely as deductions from the cost amounts of the portfolios at the end of the respective years, they differed from reserves which, after being created, were charged with realized investment losses. The reserve was adjusted at each of these year-ends through surplus account, which account carried the realized losses. This treatment is similar to the instances where the portfolio was carried at the lower of cost or market, and where the adjustment was made directly through surplus account. In this instance, however, there existed the advantage that trading results were based on original costs rather than on adjusted book values.

In 1934 this procedure ended, and thereafter the books reflected portfolio at cost, as was the practice prior to 1930.

However, the company in the reports to stockholders as at December 31, 1930, 1931 and 1932, did not disclose the cost of the portfolios. These portfolios were shown at those dates at the lower of cost or market. Neither the cost amount nor the reserve amount was disclosed. Since also there were not provided in these years any analyses of surplus accounts, through which portfolio values were adjusted, stockholders could not ascertain the extent of these adjustments.[56]

c. American International Corporation

The case of American International Corporation illustrates the distortion of the trading results which was achieved by the utilization of the reserve account. This company maintained a reserve beginning October 31, 1924, when the company reduced the net value of securities owned to market value as of that date. On January 1, 1927, the balance of the reserve account was $8,185,196. Subsequently, certain security profits and losses were added to and deducted from the balances in this reserve, while other security profits and losses were posted to income account. From 1927 to 1929, this corporation disclosed in the published reports only the investment profits and losses carried to income account. The company made no disclosure in published reports for this period of the substantial amounts of trading profits and losses transferred to reserve account.

For the years 1927, 1928 and 1929, the stockholders were informed through the published income accounts, that security trading resulted

[54] See also p. 2017, infra, for a discussion of the dividend record of this company.

[55] For details, see analysis of surplus account of this company, infra, pp. 2031–37.

[56] See infra, pp. 2064–65.

in profits aggregating $11,221,775. The actual result was a profit of only $7,827,072, a discrepancy of $3,394,703. This difference represented the aggregate 1927–1929 net losses carried to reserve account, of which the stockholders were not informed.[57] The details of the distorted picture of trading results furnished to the stockholders in the three years, 1927 to 1929, are as follows:

	Year ended Dec. 31—		
	1927	1928	1929
Profits upon sales of securities, syndicate operations, and from credit participations *as reported to stockholders:*			
1927:			
Investment profits realized	$787, 987. 86		
Profit from syndicate and credit participations	65, 353. 26		
Total	853, 341. 12		
1928 and 1929:			
"Investment profits realized—less amounts appropriated as reserve against securities owned"		$2, 103, 687. 14	$8, 264, 747. 44
Realized net profits or (losses) carried to reserve, but not disclosed to stockholders	(3, 535, 334. 75)	(1, 500, 023. 11)	1, 640, 654. 32
Net profits and (losses) upon sale of securities, syndicate operations, and from credit participations, per books (profits per income account adjusted by profits or losses carried to reserve but not disclosed to stockholders)	(2, 681, 993. 63)	603, 664. 03	9, 905, 401. 76
Net operating income, representing excess of earnings, including only reported net realized profits over deductions consisting of operating expenses, interest and taxes, other than income taxes, *as reported to stockholders:*			
Amount	2, 015, 241. 78	3, 060, 839. 51	9, 039, 033. 31
Per share	4. 11	6. 25	8. 86
Net operating income shown above, after deduction or addition for profits or losses carried to reserve, but not reported to stockholders:			
Amount	(1, 520, 092. 97)	1, 560, 816. 40	10, 679, 687. 63
Per share	(3. 10)	3. 18	10. 47

These amounts reported to the stockholders were not only misleading, but the language adopted to describe the trading results of 1928 and 1920 was ambiguous and added to the deception latent in the figures. The descriptions read: "Investment profits realized—less amounts appropriated as reserves against securities owned." The impression which was created by this descriptive matter was that the amount of the investment profits for the year 1928 having been reduced by certain appropriations, was larger than the amount reported. The true results, disclosed in the above table, differed substantially from those which the management chose to reveal to the stockholders in the published reports.

The publication of profits and losses upon the sales of securities, which purported to be for the fiscal year covered by the stockholders'

[57] In the 1930 report, the variance between published results and actual trading results for the year was $2,749,517.40. This 1930 deficiency is treated in detail infra.

reports, but which varied materially from the real result recorded on the books, continued in 1930. The Summary of Income and Profit and Loss for 1930 contained an item of "Investment Profits Realized" of $3,112,887.78. Beneath this income statement, and for the first time, there was a "Summary of Charges and Credits to Reserve for Securities," which summary informed the stockholder that realized losses aggregating $5,976,305.94 were charged during the year to the Reserve. When the profit of $3,112,887.78 shown in the published summary of income account is deducted from the losses of $5,976,305.94 revealed in the published analysis of the Reserve account, the net losses for the year from the sales of securities would seem to be $2,863,418.16. Actually, as disclosed by the books, the losses sustained in 1930 totaled $5,612,935.56. The discrepancy between the published accounts and the actual amounts as shown by the books is $2,749,517.40. The analysis of the reserve account furnished to the stockholder was so incomplete as to fail to reveal a transfer of "profits allocated to income" of the sum of $2,749,517.40 from reserve account to income account. Thus, the amount of $2,749,517.40, representing profits of previous years, including the profit of $1,640,654.32 not reported to the stockholders in 1929, was added to the 1930 item of Investment Profits Realized, increasing it to $3,112,887.78, and appearing as such under earnings for that year. Accordingly, the item of Operating Income, reported as $3,330,136.01 for the year 1930, was inflated by this transfer from Reserve of $2,749,517.40. The stockholder was not informed, in the published reports, of this element of inflation present in the income statement.

Harry A. Arthur, president of the corporation, when examined with respect to the figures included in the published report as at December 31, 1927, testified: [58]

Q. Let us assume, Mr. Arthur, that I was interested in your American International Corporation and wanted to buy some of your stock in 1928. I took a look at the certified balance sheet and profit and loss statement of the American International Corporation. Would there be any way that I could tell that instead of making a $787,000 profit on the sale of your securities that the corporation really lost $2,669,000 [59] on those securities?

A. I don't think so.

As to the information contained in the published report as at December 31, 1928, Mr. Arthur testified: [60]

Q. Now, according to that report, for the year 1928, Mr. Arthur, it shows the operating income of $3,060,839.51, in which is included an item, "Investment profits realized, less amounts appropriated as reserve against securities owned, $2,103,687.14." The fact of the matter is, is it not, that if you took the cost of the securities, and subtracted the selling price, the realized profit on your investment would only be $603,664.03?

A. That is correct.

Q. And on the basis of that computation, the operating income per share outstanding would not be $6.25 as Mr. Brush stated to the stockholders in his accompanying letter, but would only be $3.18, isn't that so?

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[58] Public Examination, American International Corporation, at 6723.

[59] This amount is an approximation. The exact amount is $2,669,235.76, which differs from the loss of $2,681,993.63 for the year 1927, shown in the table supra, because of an item of $12,757.87, representing a loss recorded separately.

[60] Op. cit. supra, note 58, at 6726-7.

A. That is approximately correct.

Q. Was there any indication in this report to stockholders that any basis other than cost was being used to compute the so-called realized profit on the sale of the securities during that year?

A. Unless it was the notation on the income statement, if you will turn to page 9 of that report.

Q. Less amounts appropriated against reserves?

A. That is investment profits realized against "Amounts appropriated as reserve against securities owned."

Q. But that does not show, and doesn't that give you the impression, that there was even a greater profit realized on those investment securities because a part of that profit was appropriated or allocated to reserve?

A. That is right.

Q. So that not only does that annotation not help to give the correct picture, but if anything, that item would seem to give the impression that the investment profit realized of $2,103,687.14 was not the entire profit but that a greater profit had been realized on those securities, isn't that so?

A. Yes, sir.

With respect to the information given to stockholders in the published report as at December 31, 1929, Mr. Arthur's testimony was as follows: [61]

Q. Now, the summary of income and profit and loss shows that the operating income for the year 1929 was $9,039,033.31, isn't that so?

A. That is right.

Q. And included in that item was "Investment profits realized less amounts appropriated against reserve against securities owned, $8,264,747.44," isn't that so?

A. That is right.

Q. Now, the fact of the matter is that during the year 1929, if you took the difference between the cost of the securities you sold, and the selling price of the securities that you sold, you got a figure of $9,905,401.76.

A. Yes, sir.

In connection with reserving the 1929 profits, Mr. Arthur testified that they were applied in the succeeding year, as follows: [62]

Q. Now, out of the realized profit, approximately $1,000,000 was put into reserve without any disclosure as to the amount that was put into reserve?

A. Yes, sir.

Q. Now, Mr. Brush had the right, under his own analysis of what he was doing, to take any part of that reserve and show it up as a realized profit in any succeeding year, isn't that so?

A. That is what he did.

Q. That is what he did?

A. Yes, sir.

Q. So that in 1930, the figure relating to profit realized, or loss realized, on securities sold for the year 1930 did not represent the profit or loss on the securities actually sold during that year, but included also part of the profit that they made on securities that were actually sold during the year 1929, isn't that so?

A. That is correct.

* * * * * * *

[61] Id., at 6727–8.

[62] Id., at 6735–6.

Q. Now, that $3,112,887 which is down in investment profits realized, included the $1,000,000 which was placed in the reserve during the year 1929, isn't that so?

A. I should say so.

Q. And there is no disclosure at that point that that investment profit realized figure includes profits that were made in 1929, is there?

A. I can't see any.

William H. Bell of the firm of Haskins & Sells, public accountants, which certified the reports of the corporation, testified: [63]

Q. I mean, at the time the suggestion was made that $1,000,000 of this investment profit realized should be put into a reserve and only $8,000,000 disclosed to stockholders in the profit and loss account, did you have any discussion with Mr. Brush as to the advisability of it?

A. Of course, that is not the way it happened.

Q. How did it happen?

A. If I understand it right, and I think I do, in 1927 and 1928, and in 1929—1927 to some extent, 1928 and 1929 to a greater extent, when part of a block of securities were sold at a profit, all or most of such profit would be reserved, not taken into income at once.

Q. Who determined how much should be reserved and who determined how much should be disclosed?

A. The company.

Q. Did they discuss with any member of your firm the theory or basis of taking so much for reserve?

A. Yes, I have no doubt.

Q. All right.

A. And in 1927 there were a few such things, and we gave them consideration, and it looked as though there was no question but what it was a matter for the discretion of the company, because they were sales—I believe in one case the correction of the sales price was questionable, and in another case it appeared quite doubtful whether the remainder of the block of securities could be disposed of without taking a loss, so nothing was said about it.

Q. Although you did not like it, frankly?

A. Well, I wouldn't go quite as far as that.

Q. At least, it was a little out of the ordinary.

A. I think it would be better—would have been better if they had taken up these profits and then shown an appropriation to reserve, or at least if they had said, profit so much, less blank dollars reserved, so as to give anybody the information. I have said that before.

* * * * * * *

Q. First, generally, has it been your experience that at least some influence is exerted by managements upon independent auditors, with respect to the form of financial statements and the manner of reporting to stockholders?

A. Well, it varies, of course, with the tendencies, and idiosyncrasies of different individuals, that is, their background, and some executive officers have—they are as good accountants as you are, for example, and some are better, and some wash their hands of it and some take a decided interest in it, and some have peculiar notions that accountancy is a necessary evil, and to be only tolerated and get the most they can for their own interests out of accountants' financial statements, and generally speaking, however, public accountants don't have any

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[63] Id., at 6762–3, 6772–3, 6777–8.

very great trouble with executive officers of companies, in having them issue financial statements which are acceptable to the public accountants.

There are a few exceptions to that, of course, but not noteworthy, and reputable public accountants will naturally certify to financial statements in a form desired by the executive officers, provided they think that there is no transgression or violation of any essential of vital accounting principle.

I think that is about all I can say about that, unless I failed to cover some point that you have in your mind.

* * * * * * *

Q. Of course, I think from your testimony, that one would be warranted in coming to the conclusion that the profit and loss account, if there is an item of profits on the investment of securities, if any basis other than actual cost is used, there should be a disclosure on that basis, also, in addition.

A. Yes, I agree to that. This is all constructive and for the future, and I think it is a good job you people are undertaking in that respect.

* * * * * * *

Of course, this creation of reserve is nothing but a bookkeeping expedient, and they could have either created a reserve over on the right-hand side of the balance sheet, or actually written down the securities, to what was considered their value at that time and it really makes no difference, and the cleanest way to have done it would have been to actually write down the book value of those securities, and then said all of the time from there on, this is based on market values of 1924.

* * * * * * *

I think that this case furnished a number of good points for you, that there ought to be a full disclosure of any reserves, and I think that as a rule the company ought to have the right to create reserves, and its manner of accounting in connection therewith, ought to be fairly disclosed to the public. There ought to be a statement, not only of the surplus account, but obviously of a capital surplus as well as an earned surplus account, and any forms of appropriated surplus, approaching, let us say, reserve for contingencies, because those things are subject to abuse; but not going into things that are recognized practice now, such as showing the market value of securities, and changes in unrealized profit or loss, because they are generally recognized. They are all good things.

In 1931, the American International Corporation discontinued the practice of maintaining reserves for securities and transferred the balance of $8,000,000 in the reserve account as at December 31, 1930, to earned surplus. Hugh A. McCormack, formerly associated with Haskins & Sells, explained the reason for the change as follows: [64]

Mr. Brush decided to abandon the method of setting aside profits as reserve, to discontinue that entirely. That was because of pressure brought by the Stock Exchange. So that in the year 1930 all its reserves were practically cleaned out.

d. Shenandoah Corporation [65]

Shenandoah Corporation used the reserve account similarly to American International Corporation in that income account was benefited by realized profits, while realized losses were carried in reserve account, and also in the respect that the losses in reserve

[64] Id., at 6785.

[65] This closed-end company is not included in the group of 62 companies whose accounting practices are discussed in previous sections.

account were not disclosed to the stockholders. In its published report for the period ended December 31, 1929, the income statement contained the item "profits realized on sale of securities (net)—$2,675,200.15." No reference was made in the report to a loss of $16,218-262.42 which had been charged to a reserve account, created from capital surplus, an analysis of which reserve was not submitted.

This practice probably was influenced by the resolution approved at the initial meeting of July 23, 1929, of the board of directors of this company:

> That the corporation shall not pay dividends on common stock out of paid-in surplus but only out of earned surplus, and in the event that dividends are paid on the preference stock out of paid-in surplus, such paid-in surplus shall be replaced before dividends are paid on the common stock.

The company in 1929 paid a stock dividend of 1½% to the common-stock holders out of earned surplus account, which was charged $1,162,680.33 for this dividend. A dividend was also distributed on the optional 6% Convertible Preference Stock, payable in common stock, for which earned surplus was charged $737,145.38. However, this charge was reduced by a credit of $262,500 for cash received from subscribers in respect of accrued cash dividends on preference stock. These dividends were distributed out of earned surplus, which at that time was comprised of the net income for the year published at $2,923,407, inclusive of the realized profits of $2,675,200, but exclusive of the undisclosed realized loss of $16,218,262 handled through reserve account.

e. Petroleum Corporation of America

A more recent instance of the failure to disclose realized losses charged off against reserves is that of Petroleum Corporation of America. During 1934, Petroleum Corporation of America wrote off $1,984,884, representing the loss on a participation, with its sponsors, Bancamerica-Blair Corporation and others, in the Mission Securities, Ltd. syndicate formed in May 1930 to finance the purchase by Mission Securities, Ltd. of 1,000,000 shares of Tidewater Associated Oil Company capital stock. Mission Securities, Ltd. defaulted in 1932, and the syndicate was terminated in May 1934. Petroleum Corporation of America wrote off this loss in 1934 to reserves which were created in 1930 and 1931. An analysis of the reserve account was not presented in the published report of 1934, and thus a total loss of $1,984,884 in this syndicate participation remained undisclosed. The only reference to the write-off was contained in the following comment by the company's president in his letter of transmittal:

> The syndicate participation against which a reserve had been set up as shown in the report for the year ending December 31, 1933 does not appear on the balance sheet at December 31, 1934, since such syndicate has been terminated.

f. American Founders Corporation [66]

In 1930 American Founders Corporation relegated realized losses on portfolio transactions to an obscure place in reserve account, while

[66] This closed-end company is not included in the group of 62 companies whose accounting practices are discussed in previous sections.

realized profits were published conspicuously in income account. The item "profit on sale of securities (net)" was included as an item of income in the profit-and-loss statement, but realized losses were revealed in a footnote as a charge to reserve account. The published report for the year ended November 30, 1930, contained a Statement of Consolidated Income and Profit and Loss, as follows:

EXHIBIT III. AMERICAN FOUNDERS CORPORATION

And the following subsidiaries: International Securities Corporation of America, Second International Securities Corporation, United States & British International Company, Ltd., American & General Securities Corporation, and American and Continental Corporation.

Statement of consolidated income and profit and loss for the year ended Nov. 30, 1930

Income:		
Interest	$4,760,216.42	
Dividends (including no-stock dividends)	5,134,582.30	
Profit on sale of securities (net)	4,673,478.93	
Profit on syndicate participations, investment service fees (other than fees paid by subsidiaries) and miscellaneous income	444,459.85	
Gross income		$15,012,737.50
Expenses, interest, and taxes:		
Interest and amortization of discount	2,976,424.74	
Taxes paid and accrued	280,698.27	
Miscellaneous expenses and investment service fees	1,541,812.16	
		4,798,935.17
Net income before appropriations and dividends		10,213,802.33
Net appropriations by subsidiary companies for bond interest and preferred share dividend reserves		263,889.11
		9,949,913.22
Dividends on shares of subsidiaries held by public:		
On preferred shares	492,298.73	
On common shares	366,246.94	
		858,546.67
Undistributed net income		9,091,367.55
Less: Proportion of undistributed net income applicable to minority shareholders of subsidiary companies		936,856.44
Balance of income applicable to American Founders Corporation shares		8,154,511.11
Preferred share dividends paid and accrued		856,996.81
		7,297,514.30
Appropriated for preferred share dividend reserve		417,345.86
Balance of income available for common shares		6,880,168.44
Stock dividends (credited to capital stock at $3 per share) paid on common shares		[a] 1,482,870.89
Balance of income (exhibit II)		5,397,297.55

[a] Not including a special cash dividend amounting to $2,819,263.70 declared on Dec. 2, 1929, and paid Feb. 1, 1930, out of undivided profits as of the close of the preceding fiscal year, Nov. 30, 1929.

NOTE.—Surplus of $12,076,041.99 created through the retirement by American Founders Corporation and its subsidiaries of preferred shares acquired by them below par, was transferred during the year to investment reserves against which losses amounting to $11,373,318.44 were charged.

g. Central States Electric Corporation

A variation of the use of reserve account was to charge to that account a write-down of a security just prior to its disposition. Accordingly, realized profits were published in an amount which was relieved of the pressure of a realized loss. This use of a reserve account was made by Central States Electric Corporation, and the procedure in the course of which this was accomplished is described in the president's letter accompanying the company's report for 1931, as follows:

At the last annual meeting of the Corporation, the stockholders took appropriate action to reduce the stated capital of the Corporation by $11,897,373, and to authorize employment of the surplus created thereby for the purpose of writing down the investments of the Corporation, and for creating such reserves and for such other purposes as the Board of Directors might deem desirable. Accordingly, the $11,897,373 of surplus created by the capital reduction was set up as an investment reserve. From it an appropriation of $5,239,563 was made to write down certain stock sold during the year and in consequence neither profit nor loss is recorded with respect to this sale. All other securities sold during the year resulted in a net profit of $747,776, which has been carried directly to surplus, rather than through income as heretofore, in accordance with a change in practice adopted by the Corporation in reporting results of sales of securities.

This procedure was described also in a footnote to the consolidated income account for the year 1931 as follows:

An appropriation of $5,239,563 was made from investment reserve (created out of capital surplus) in reduction of the book value of an investment, applied to portion thereof sold during the year and in consequence neither profit nor loss is recorded with respect to this sale. A credit of $747,776 for net profits realized on sale of other securities during the year is also omitted from income and carried directly to surplus.

However, a material point of information not revealed in any part of the published report was that the stock written down in reserve account prior to its disposition was that of an affiliate, The Goldman Sachs Trading Corporation.

h. Blue Ridge Corporation

In the Blue Ridge Corporation the management created reserves affecting investments but the published report for the year ended December 31, 1931, did not disclose the composition of the reserves nor the amounts reserved. The failure to furnish these details provides a means to cover up results of deals and operations connected with investments.

The consolidated balance sheet contained in that report is reproduced below:

Blue Ridge Corporation and Wholly Owned Subsidiaries Consolidated Balance Sheet Dec. 31, 1931

ASSETS

Investments:		
Listed securities, at cost, less reserve	$105, 189, 322. 46	
Less capital surplus carried as reserve, per statement attached	60, 344, 421. 73	
(Market value Dec. 31, 1931, $40,667,554)	44, 844,900. 73	
Unlisted security, at cost, less reserve, estimated fair value	1, 488, 000. 00	
Note receivable, secured, less reserve, estimated fair value	2, 100, 000. 00	
		$48, 432, 900. 73
Accounts receivable		1, 545. 54
Dividends receivable and interest accrued		714, 061. 44
Cash		1, 907, 991. 36
		51, 056, 499. 07

LIABILITIES

Accounts payable		12, 894. 21
Reserve for accrued expenses		69, 025. 44
Reserve for contingencies		158, 746. 00
Capital stock:		
Preference stock, par value $50; authorized 10,000,000 shares; outstanding, 806,202 shares cumulative optional 6% convertible preference stock, series of 1929	$40, 310, 100. 00	
Common stock, no par value; authorized, 30,000,000 shares;[a] outstanding, 7,489,297 shares	7, 489, 297. 00	
		47, 799, 397. 00
Operating surplus, per statement attached (subject to statements per contra relating to investments)		3, 016, 436. 42
		$51, 056, 499. 07

[a] Common stock reserved for (a) conversion of preference stock, 1,209,303 shares, (b) dividends on preference stock, 1,143,104 shares (maximum annual requirement 100,775 shares), and (c) exercise of warrants (to purchase at any time shares of common stock at $20 per share) issued as of Jan. 1, 1930, to Shenandoah Corporation, 228,301 shares.

A brief history, to the end of 1931, of each of the various reserve accounts referred to in this balance sheet under the caption "Investments," is as follows:

Listed Securities, at Cost, less Reserve ---- *$105, 189, 322. 46*

In accordance with a resolution of the board of directors on December 4, 1929, the corporation created a reserve from capital surplus amounting to $35,772,618, to provide for a reduction in the valuation of listed securities from cost to market as at November 27, 1929. No substantial additions were made to this reserve to December 31, 1931. The charges against the reserve (less a small credit thereto), consisted of a portion of the losses on sales of securities, and the restoration to

capital surplus of amounts previously provided in the reserve in excess of losses sustained on actual sales, reduced the balance in this account, as of December 31, 1931, to $19,178,460.14. At the time this reserve was created on December 4, 1929, a "Special Reserve for Investment in Central States Electric Corporation Common Stock," in the amount of $4,891,774, was also created by a charge to capital surplus. The latter reserve remained unchanged. These two reserves, aggregating $24,070,234.14, were applied as a unit in the reduction of the cost value of investments in listed securities, $129,259,556.60, resulting, as seen in the published balance sheet, in a net figure of $105,189,322.46. No explanatory matter was submitted of the composition of the reserves which had been used in arriving at the balance-sheet value of listed securities. No reference to the amounts of these two reserve accounts appeared anywhere in the published report.

The reserve of $4,891,774 represented a cross-holding reserve established to reduce the valuation of investment in common stock of Central States Electric Corporation, in order to give effect to adjustments due to holdings by that company of capital stock of its parent, Shenandoah Corporation.

As to this reserve, the president, C. F. Stone, stated, in his letter to the stockholders accompanying the report of December 31, 1931, as follows:

> The cross-holding reserve, in reduction of market value, heretofore set up in connection with valuation of certain assets, has been omitted in the accompanying accounts, as not being applicable under conditions existing at December 31, 1931.

However, the information submitted in answer to the questionnaire indicates that the corporation continued to carry this reserve until December 31, 1932, the effective date when the reserve was utilized to write down, in part, the value of investments pursuant to the authority granted at a stockholders' meeting held in February 1933. The figure of $105,189,322.46 represented nothing more to the stockholder than the investments of his corporation in listed securities at an undisclosed cost, less an undisclosed amount of reserve.[67]

It will be noted that the entire balance in capital surplus account of $60,344,421.73 was applied as an additional reserve to reduce the carrying value of listed securities on the balance sheet to $44,844,900.73.

Unlisted Security, at Cost, Less Reserve—Estimated Fair Value____ $1,488,000.00

The next item appearing in the balance sheet is represented as "Unlisted security, at cost, less reserve—estimated fair value . . . $1,488,000.00." The investment, shown as an "unlisted security," represented holdings by Blue Ridge Corporation of 39,200 shares of Blyth & Co., Inc., at a cost of $2,940,000.00. This investment was carried at an estimated fair value of $1,488,000, the difference between cost, $2,940,000.00, and reserve, $1,452,000.00. The reserve was created from capital surplus. The corporation gave no indication to

[67] See also other aspects of these reserve accounts with relation to the company's capital surplus account of 1929 when the said reserves were established. These other aspects are discussed in Sec. D, 3, infra.

stockholders of the amount or of the source of the reserve that had been created.

Note Receivable, Secured, Less Reserve—Estimated Fair Value____ $2,100,000.00

Another asset against which a reserve was created, the details of which were not disclosed to stockholders, consisted of a note receivable from Condé Nast in the amount of $4,800,000 received on December 31, 1931, by Blue Ridge Corporation as consideration for the sale on that date of 160,000 shares of the common stock of Condé Nast Publications, Inc. The note was guaranteed by The Vogue Company, Condé Nast, Inc., and the Montrose Development Company, and was collateralized by 1,031 shares of Blue Ridge Corporation and other securities and property. The Condé Nast Publications, Inc. stock sold to Mr. Nast had been received by the Blue Ridge Corporation on the same date through purchase from the Chase National Bank, in accordance with an agreement entered into on October 24, 1930, to purchase such stock in the event of nonpayment of a loan of $4,000,000 made by the bank to The Vogue Company.

At the time of the receipt of the said note of Mr. Nast of $4,800,000, a reserve of $2,700,000 was created to meet the deficiency in value of the underlying collateral which was appraised at $2,100,000. The reserve was built up by two amounts; (1) the excess of $800,000 of the note of $4,800,000 over the cost of the stock delivered of $4,000,000, and (2) by an amount of $1,900,000 allocated from capital surplus. This information was not revealed in the published report.

i. Summary of Practices Re Portfolio Reserves

Of the 14 open-end companies under review, only two carried portfolio reserves. Of these two, one company charged security losses to reserve account, an analysis of which was published. The other used its reserve account to adjust the value of the portfolio to the lower of cost or market at each year-end, via surplus account, but did not reveal the amounts of the reserves nor furnish an analysis of the surplus account, through which the reserve account was adjusted.

Of the 62 closed-end companies under review, 25 carried investment reserves. Reserves of 12 companies were charged with trading losses. Reserve accounts of the remaining 13 companies served solely as offsetting amounts to the carrying value of investments. Among these were reserves of two companies which were set up against shrinkage in value of investments in subsidiary companies only and were retained at a constant amount over a period of years.

An examination of the practices connected with the carrying of these reserve accounts revealed that only in the cases of eight of the 25 closed-end companies were adequate analyses of the reserve accounts published. Of the 17 other companies, 14 furnished no analysis, while two submitted inadequate analyses and one published no income account for several years. Such important items as amounts of realized losses were concealed by this absence of analysis. However, among the 17 companies which furnished no analysis of the make-up of the reserve accounts, nine revealed the balance existing in the account. Thus, in the cases of these nine companies and of the eight companies which provided full analysis, the stockholders were at least

informed of the balances remaining in reserve accounts. In the instances of eight companies, the stockholders knew nothing of the reserve balances carried on the books.

Such distorting and misleading accounting procedures connected with the handling of investment reserve accounts offset in part the useful function of reserve accounts of reflecting unrealized depreciation as compared to the method of reflecting such depreciation directly in investment accounts. As reviewed, the reserve-account method preserved, while the investment-account method abandoned, original cost as the basis for computation of profit or loss upon the disposition of the securities involved.

The Companies Act of 1938 of the Commonwealth of Australia (sec. 592) requires that all security profits and losses shall be carried in the investment fluctuation reserve account, and that the reserve balance shall not be available for dividends, viz—

> (1) All profits and losses of an investment company from the purchase and sale of securities shall be respectively credited and debited to a reserve account to be kept by the company and to be called the investment fluctuation reserve.
>
> (2) The investment fluctuation reserve shall not be available for the payment of dividends.

Similarly, it is the general practice of investment trusts of Great Britain to transfer all investment profits to a reserve for the purpose of covering deficits arising from security losses.[68] Where security profits are held in reserve for the above purpose, such profits are exempt from the normal income tax of Great Britain and are prohibited from being disbursed as dividends.[69]

6. ACCOUNTING METHODS USED IN CONNECTION WITH PARTICIPATIONS IN UNDERWRITINGS, SYNDICATE OPERATIONS, COMMODITY TRANSACTIONS, AND JOINT ACCOUNTS

Of the 62 closed-end companies reviewed, 31 participated in underwritings, syndicate operations, commodity transactions, or joint accounts. Among the 14 open-end companies, apparently only one company engaged in any such activities.

The distinctiveness of such operations by an investment company is such that a segregation of the results therefrom in published reports ought to be plainly a necessity. While all companies engaged in these operations maintained accounts which reflected results from such operations separate and apart from accounts reflecting ordinary trading results, nevertheless 13 of the said 31 closed-end companies consistently refrained from distinguishing these results from results of other operations in stockholders' reports. One company issued no reports. Of the 17 closed-end companies which separated the results of these activities for the special notice of the stockholders, 14 did so consistently during their entire period of such operations, and three, after being among the companies which failed to segregate, joined those which isolated the said results in published reports beginning

[68] See the Commission's report on Investment Trusts in Great Britain.

[69] Ibid.

with 1930. The single open-end company which participated in such activities treated the results thereof in published accounts as a separate item.

In the operations pertaining to underwritings, syndicates, and joint accounts, at least two common practices were found which dealt with the take-down of the securities involved at the termination of each of such ventures. These accounting practices may be summarized as follows:

1. Securities taken down at the end of operations were carried at cost and unrealized appreciation or depreciation in value was not reflected on the books. Any commissions received or any profits realized in the deals were recorded in a separate account and not as offsets to cost in investment account.

2. Securities taken down were entered at cost, but any selling commissions and any profits obtained in the course of operations were applied in reduction of this cost. Unrealized appreciation or depreciation in value was not reflected on the records, but any depreciation was lessened, or any appreciation was increased by the amount of commissions and profits entered as offsets to original cost.

a. Central States Electric Corporation

Central States Electric Corporation opened a joint trading account with The Goldman Sachs Trading Corporation in Shenandoah Corporation's common and preferred stock on August 20, 1929. On December 17, 1929, this account was closed. The securities taken down at the cost shown, and the unrealized depreciation at the time of the take-down, were as follows:

	Shares	Cost	Unrealized depreciation
Shenandoah Corporation preferred	88,580	$5,018,093	$2,227,823
Shenandoah Corporation common	98,698	3,286,189	2,434,918
	----------	8,304,282	4,662,741

The books recorded for 1929 a net profit of $391,049 on "joint accounts and/or syndicate undertakings." The above depreciation of $4,662,741 was not reflected upon the books.

In the company's published "Income Account for the Year" the said profit of $391,049 was not shown separately, but was included in the total given as profits on the sales of securities.

b. Shenandoah Corporation

Shenandoah Corporation followed the above method upon occasion, but in at least one instance the shares taken down were entered at market which was higher than cost.

During 1930 this company acquired from a syndicate in which it was a participant a block of stock of the Kraft-Phoenix Cheese Company, Inc. At the time of acquisition, market value exceeded cost by the sum of $331,776. This block was valued upon the books at market value, and the amount of $331,776, representing the excess of market value over cost, was reflected as a profit in syndicate account.

In the same year, 1930, the company took down from a syndicate, of which it was a member, a block of stock of The Goldman Sachs Trading Corporation. The market value of this stock at date of acquisition was $1,152,255.30 less than cost. This depreciation was not reflected on the books. The published reports failed to account separately for the results from syndicate operations. Profits from such activities were included in the total stated as the result for the year from trading in securities.

7. ACCOUNTING WITH RESPECT TO REACQUIRED SHARES OF THE COMPANY'S OWN STOCK (TREASURY STOCK)

Previous sections of this chapter dealt with the accounting practices pertaining to transactions in portfolio securities. This section deals particularly with accounting practices in connection with the investment company's own security issues—its issues of stock reacquired by the investment company, commonly referred to as treasury stock. This section deals with the accounting treatment of reacquired stock on hand, and of reacquired stock disposed of or retired.

As at the year-end 1935, a majority of the closed-end companies which held treasury stock treated such holdings as a deduction at the stated or par value from total shares and total par or stated value of stock issued.

However, prior to the time that a majority of the closed-end companies under review regarded reacquired stock as a diminishment of capital stock account, a number of these companies, together with other closed-end companies which are still present among the minority, treated reacquired stock as an item to be included among the assets. A difference of opinion existed and still exists as to the basis to be used for the evaluation of the reacquired stock. The minority showed the reacquired stock at cost or market, as compared to the majority which carried the said securities at par or stated value.

Reacquired securities, where shown among the assets, and not as a reduction of capital, were so treated upon the theory that such securities were held with the expectation of resale within a short time. Although authority for such treatment exists,[70] other authorities treat reacquired stock not, strictly speaking, as an asset, but as constituting a means for obtaining assets.[71]

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[70] For example, William H. Bell, a member of the firm of Haskins & Sells, in *Accountants' Reports*, 3rd rev. ed. (1934), p. 68, states:

> Treasury stock held with the expectation that it will be resold shortly should be shown as an asset, as a separate item, and valued at the lower of cost or market, or, if donated, at a nominal value. * * * If it is held without definite expectation that it will be thus sold or reissued, it should be adjusted to par or stated value and shown as a deduction from the stock issued * * *.

[71] *A Statement of Accounting Principles*, prepared by Messrs. Sanders, Hatfield and Moore, p. 90.

Among the companies which did not classify reacquired stock as an asset, four closed-end companies considered such stock as an item for deduction from the total of capital and surplus, three companies making the deduction at cost, while one company made it from time to time at various valuations.[72]

a. Central States Electric Corporation

An instance was observed where on the face of the same financial statement one lot of reacquired securities was classified as an asset, while another lot was handled as a deduction from capital.

At December 31, 1929, Central States Electric Corporation held the following issues of its own securities:

	Number of shares	*Carrying value*
$800,000, 5% convertible debentures	------	$678, 940
7% preferred stock, at par	6, 078	607, 800
6% preferred stock, at par	6, 260	626, 000
Convertible preferred, at par	51, 179	5, 117, 900
Common stock, no par	4, 640	4, 640

Upon the published balance sheet as at December 31, 1929, the first two items were shown as assets, at the values shown, while the next three items were designated as "Held in Treasury," but were shown as deductions from capital stock account.

At December 31, 1930, reacquired debentures and 7% preferred stock were classified, as they were in 1929, as assets, and upon the same bases of valuations. No preferred shares of other series were on hand December 31, 1930. However, a block of common stock reacquired was on hand at this date, and, again, as in 1929, this stock was treated differently from reacquired preferred stock in that the common stock was deducted from the total common stock issued at $1 per share.

At December 31, 1931 and 1932, the practice was varied. All reacquired preferred shares on hand were included among the assets, at cost—a change from the previous practice of including them at par. Reacquired debentures no longer were itemized among the assets, but were shown as a deduction at face value from debentures issued. The handling of reacquired common shares was the same as at the end of previous periods—a deduction at $1 per share from common stock issued.

For the end of each period, 1933, 1934, and 1935, an additional change was effected in that all reacquired securities, debentures at face value, preferred shares at par, and common stock at its then par of $1 per share, were deducted from the totals issued.

b. American International Corporation

The management of American International Corporation for a time treated reacquisitions of the company's own issues of securities as in the nature of investments, and such reacquisitions were not disclosed as such to stockholders and the investing public.

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[72] Also, in this respect, see the Commission's Regulation S–X, Rule 3.16 (effective February 1940), which reads: "Reacquired shares, if significant in amount, shall be shown separately as a deduction from capital shares, or from the total of capital shares and surplus, or from surplus, at either par or stated value, or cost, as circumstances require."

At December 31, 1929, the company held in its portfolio reacquired debentures with a face amount of $1,500,000, and its own common shares repurchased at a cost of $1,333,920. A year later at December 31, 1930, its own debentures in portfolio totaled $1,237,000 in face amount. No reacquired common shares were on hand. In the balance sheets for the respective year-ends the reacquired securities were incorporated in the item of securities owned. No segregation of the securities reacquired was made in the report to stockholders and investors. This aspect of the treatment of corporate securities repurchased was explained by Hugh A. McCormack of Haskins & Sells, accountants for the company during these years, as follows: [73]

Q. Now you say there was another time when you had some discussion with Mr. Brush [president] with respect to the manner in which the operations of the company should be reported to stockholders. When was that, and in what connection do you recall?

A. That was in connection with the treasury securities that they carried as investment. I discussed the matter with Mr. Brush and he maintained it was a matter of policy that they bought those the same as they bought any other security, for resale at a profit. It was a good investment, they thought, because they knew all about them, in the first place. They knew they were worth more than they were selling for, and he said to publish that would make a disclosure of managerial policy that he was not willing to make.

Q. Namely, that they were purchasing their own securities?

A. Yes.

Q. Did you agree with that?

A. I didn't thoroughly agree with it, but I referred the matter to Mr. Palmer, who was the partner in charge of the work I was doing, and of course I gave Mr. Brush's idea of what the thing was, and he evidently accepted it.

Q. Subsequently, however, that was changed, wasn't it?

A. That was changed subsequently, because there was also another Stock Exchange measure where they frowned or disapproved of these companies buying and selling their own securities, so the American International Corporation discontinued the practice entirely, and what securities they held were afterwards taken out of their investments and deducted on the other side of the balance sheet.

c. Summary of Practices

Of the 62 closed-end companies reviewed, 41 held their own reacquired security issues at fiscal year-end periods. Five different methods of treatment of the reacquired securities in published reports were used. If the variance of valuations be considered as distinctive methods, at least eight different procedures were employed (Table 38). Some companies changed from one method to another, but considering the method last in use, 24 of the 41 companies carried the item as a deduction from securities issued, 16 at stated, par or face values, and 8 at cost. Ten companies showed the item as an asset, nine at cost, and one at market value. Four companies showed the item as a deduction from the total of capital and surplus, three at cost, and one at various valuations. Two organizations indicated the item as a deduction from capital surplus, both at cost. One other company practiced a combination

[73] Public Examination, American International Corporation, at 6786–7.

of methods, by showing reacquired capital stock as an asset at cost, and by deducting reacquired debentures at face amount from funded debt issued.[74]

TABLE 38.—*Methods of treatment by 41 closed-end companies in reports to stockholders of reacquired securities on hand, 1927–35*

		Number of companies
As a deduction from securities issued:		
At par or stated value		8
At cost		1
		9
As an asset item:		
At cost		8
At market		1
		9
Changed from asset item to deduction from stock issued:		
At par or stated value		5
At cost		7
These changes were made in the following years:		
1930	1	
1931	3	
1933	4	
1934	4	
		12
As an asset, common stock, at cost; as a deduction from issued stock, preferred stock, at par value, to 1930; after 1930, both common and preferred stock, as a deduction from stock issued at par		1
As a deduction from stock issued, 1929; as an asset, 1930; thereafter as a deduction from stock issued at par		1
As an asset, with respect to certain issues, and as a deduction from issued securities with respect to certain other securities, to 1933; thereafter as a deduction from securities issued at face and par values. (See comments in text re Central States Electric Corporation)		1
As a deduction from stock issued at stated or par value, 1930 and 1931; as an asset, at cost, 1932		1
As an asset, capital stock, at cost; as a deduction from funded debt, debentures, at face amount		1
As a deduction from total of capital and surplus, at cost		1
As a deduction from stock issued at par or stated value; later as a deduction from total of capital and surplus, at cost		2
As a deduction from issued stock, to 1933; thereafter from capital and surplus, at various valuations		1
As a deduction from capital surplus, at cost		1
As a deduction from issued stock, at paid-in value, 1929; as a deduction from capital surplus, at cost, beginning 1933		1

However, in addition to these 41 closed-end companies which had treasury securities at fiscal year-ends to account for in published reports, additional companies disposed of or retired such securities before

[74] Other aspects in connection with reacquired securities may be observed from the analyses of surplus accounts, infra, pp. 1999 et seq.

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the end of the accounting period. An examination of the practices followed by these companies, 47 of 62 closed-end companies reviewed, upon the disposition or retirement of reacquired securities indicated that the charges and credits which arose from the sale or from the retirement of treasury stock were carried as a general rule to capital surplus account.[75] The exception was to carry these charges and credits to earned surplus account. In some instances where capital surplus and earned surplus were not differentiated upon the records (only one all-inclusive surplus account being maintained) no distinction as to the handling of these charges and credits was made. In two instances the companies treated the charges and the credits arising from the disposition of the said securities in one manner, and the charges and credits arising from retirement in another way.

It will be observed (Table 39) that the exceptional practices comprise a large enough minority to indicate the unsettled condition which existed in the investment trust field in this respect.

TABLE 39.—*Accounts reflecting charges and credits arising from the sale or retirement of reacquired securities by 47 closed-end investment companies, 1927–35*

	Number of companies
Carried to capital surplus	29
Carried to earned surplus	4
Carried to combined surplus	5
Carried to combined surplus to 1928, thereafter to capital surplus	1
Carried to capital surplus except for 1931, when carried to earned surplus	1
Carried to capital surplus to 1930, thereafter to reserve	1
Charges and credits arising from sales carried to earned surplus	1
Charges and credits arising from sales carried to earned surplus; arising from retirement to capital surplus	2
Excess of average paid-in value over cost credited to combined surplus to December 1933, at which time a capital surplus account was established; beginning December 1933 entire cost of reacquired shares was charged to capital surplus	1
Entire proceeds from sales carried to treasury stock account	1
Reacquired shares were carried at cost for entire period; no shares retired, nor sales thereof made	1

Conditions surrounding the reacquisition of capital shares by open-end companies differ in important respects from those connected with the reacquisition of capital shares by closed-end companies. In the open-end companies a shareholder has the right, upon giving the pre-

[75] With respect to the treatment of excess of proceeds from sale of treasury stock over the cost thereof, the Commission, in its Release No. 6, Accounting Series, dated May 10, 1938, stated:

> Under the laws of most states there are certain legal restraints upon the issuance of new shares that do not apply to the sale of treasury shares. However, from an accounting standpoint, there appears to be no significant difference in the final effect upon the company between (1) the reacquisition and resale of a company's own common stock, and (2) the reacquisition and retirement of such stock together with the subsequent issuance of stock of the same class.
>
> It is recognized that when capital stock is reacquired and retired any surplus arising therefrom is capital and should be accounted for as such and that the full proceeds of any subsequent issue should also be treated as capital. Transactions of this nature do not result in corporate profits or in earned surplus. There would seem to be no logical reason why surplus arising from the reacquisition of the company's capital stock and its subsequent resale should not also be treated as capital.

scribed notice, to require the company to purchase or redeem or cause the purchase or redemption of the shares representing his proportionate interest in the company's properties or the cash equivalent of such interest; often at a small discount. Also, several of the open-end companies are not corporate in form.[76] These factors must be considered in connection with the accounting treatment of reacquired shares by open-end companies.

Of the 8 open-end companies of the 14 reviewed which had reacquired shares on hand at the end of a fiscal period, none showed these shares as an asset in published reports (Table 40).

TABLE 40.—*Methods of treatment of reacquired shares of the companies' own stocks on hand by 8 open-end companies in reports to stockholders, 1927–35*

	Number of companies
As a deduction from capital stock:	
At par or stated value	5
At cost to 1931; thereafter at stated value	1
At average paid-in value to February 1932; thereafter at declared value	1
Basis not shown; capital stock outstanding was shown net of reacquired stock	1

Table 40 relates to reacquired stock of open-end companies on hand at statement dates. Of course, all the 14 open-end organizations reviewed reacquired shares of their own issues from time to time. Table 41 describes their accounting treatment in connection with the redemption and the resale of such stock.

TABLE 41.—*Accounts to which difference between resale price or redemption price and par or declared value of capital stock reacquired was carried by 14 open-end companies*

	Number of companies
Carried to capital surplus or paid-in surplus	10
Carried to combined surplus	3
Carried to principal	1

8. TREATMENT OF THE EXCESS OF FACE VALUE OVER COST OF REACQUIRED BONDS OR DEBENTURES

With respect to investment companies' reacquired bonds or debentures, no definite trend toward a particular method for the handling of the amount of the excess of face value over reacquisition cost existed. The majority of companies reviewed carried such excess amount to earned surplus account, either directly, or indirectly through another account. The other companies carried the excess amount either to capital surplus, to special surplus, to unamortized

[76] These circumstances are dealt with specially hereinafter, and in connection therewith some important aspects, as they relate to the reacquisition of securities by open-end companies, are reviewed. See infra, pp. 2017–37.

debt discount account, or to other accounts. The excess of face amount over reacquisition cost was more or less affected by the amount of bond expense and bond discount which remained unamortized at the time the bonds or debentures were reacquired.[77]

The lack of unanimity of opinion as to the accounting treatment for these excess amounts was not only indicated by the various practices used by investment companies, but by the choice of methods suggested to investment trusts by the New York Stock Exchange:[78]

Profits arising out of the reacquisition of its own Bonds by a company may be used to diminish any unamortized bond discount and expense, credited to Earned Surplus direct and not through Income Account or credited direct to Capital Surplus at the option of the company.

Of the 62 closed-end companies reviewed, 42 did not issue bonds or debentures. Of the 20 which did issue such securities, 3 companies did not reacquire any bonds or else reacquired them at face amounts. As to the remaining 17 companies, the varied treatment of the excess of face amount over cost of reacquired bonds or debentures is presented in Table 42:

TABLE 42.—*Treatment by 17 closed-end investment companies of the amount of excess of face value over cost of reacquired bonds or debentures after giving effect to any adjustments for unamortized discount, 1927–35*

Method of treatment	Number of closed-end companies
Credited to earned surplus	7
Credited to capital surplus, or to combined surplus where no segregation of surplus was maintained	4
Credited to combined surplus, thereafter to capital surplus	1
Credited to combined surplus, thereafter to earned surplus	1
Credited to earned surplus to 1931, thereafter to special surplus	1
Credited to a reserve account	1
Credited to "discount on bonds purchased for Treasury"	1
Credited to earned surplus to 1932, thereafter to unamortized discount account	1

9. TREATMENT OF UNAMORTIZED DEBT DISCOUNT AND EXPENSE APPLICABLE TO REACQUIRED BONDS OR DEBENTURES RETIRED

Of 20 closed-end companies which issued bonds or debentures, 10 did not maintain an unamortized discount account following the issue of such securities.[79] Among the 10 remaining companies, five different methods were used with respect to the treatment of the unamortized debt discount and expense which was applicable to bonds or debentures reacquired. The variance of methods can be attributed to the varied treatment of the excess amount of face value over reacquired cost. As a rule, the procedure followed upon reacquisition of these securities was

[77] This feature is reviewed specially in the following section.

[78] Special Requirements for Listing Investment Trust Securities approved by Committee on Stock List, June 6, 1929, as amended to April 1931.

[79] For more detailed discussion see following sections.

to charge off the debt discount and expense against that account which reflected the excess amount of face value over reacquisition cost, and a number of such accounts existed.

Unamortized discount applicable to reacquired bonds or debentures was charged by three companies to capital surplus and by one company to earned-surplus account. Another company reduced unamortized discount account by a charge to earned surplus to 1931, while after 1931 this company charged the amount to a special surplus arising in part from the retirement of the company's bonds and in part from investment profits. Still another company transferred the proportionate discount amount to earned surplus from capital surplus to which all discount had been charged. Three companies did not adjust unamortized discount account upon reacquisition of the securities. Only one company applied the excess of face value over reacquisition cost to unamortized discount account.

During the greater part of the period under review (1927–1935), refunding operations had not reached the proportions of the period subsequent to 1935. Therefore, the practices indicated were not affected to an important extent by the unamortized discount and expense applicable to issues refunded and by the discount and expense relating to the issues replacing them.

10. TREATMENT OF DEBT DISCOUNT AND EXPENSE

As previously stated, 10 of the 20 closed-end companies which issued debentures or bonds did not set up in accounts to be amortized over the term of the indebtedness the amount of expense and, where applicable, the amount under face value at which the bonds or debentures were issued, generally referred to as the amount of discount. Of these 10 companies one company disposed of its bond issue at a premium, which was credited to a combined surplus account, another company issued its bonds at par, while a third company wrote off the discount prior to 1927, before the period reviewed. Of the remaining seven companies, four charged this discount item to earned surplus in the year of issue; two charged the item to capital surplus; and one charged the item first to a combined surplus account, but later transferred it as a charge to a special reserve account.

Ten other companies reviewed maintained debt discount and expense accounts, the amounts of which were amortized. However, three of these companies cut off the period of amortization after charging a proportionate amount each year for the first few years of the term of indebtedness. Two of these three companies charged off the balance against earned surplus, while the other company charged it to capital surplus. Finally, the remaining seven companies maintained an unamortized debt discount and expense account, and each year charged a proportionate part of this account to income account. Thus, only 7 of 18 companies regularly treated this item as a cost of borrowed money for the current period.[80]

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[80] In this connection the Commission has recently stated its position as follows (*In the Matter of Alleghany Corporation,* 6 S. E. C. 960 (1940)):

> Accounting authority recognizes that bond discount should be considered as part of the interest cost of the capital obtained. Discount represents the difference between the amount received on the sale of bonds and the amount required to be paid at their

11. TREATMENT OF ORGANIZATION EXPENSES

As a general rule, the investment companies reviewed did not carry organization expense as an item to be deferred beyond the year in which it was incurred.

Of the 14 open-end companies analyzed, 12 either were organized before 1927 (the first year under study) or were relieved of such expenses by their sponsors. The remaining two open-end companies, organized after 1926 and which had incurred organization expenses, charged them off against the operations of the first year.

Of the 62 closed-end companies reviewed, 15 companies were organized prior to 1927 or were saved this expense by their sponsors. Of the remaining 47 companies, only 4 set up organization expense accounts to be deferred over a period of years. The remainder, in charging off the amount of organization expense in the first year, did so by four different methods, principally as a charge to operations (Table 43).

TABLE 43.—*Treatment of organization expenses by 47 closed-end companies, 1927–35*

Procedure	Number of companies
Charged to first year's operations	30
Charged to capital surplus	5
Charged to reserve created out of the proceeds from the issue of capital stock	5
Charged to earned surplus	3
Set up as a deferred charge	4

12. SURPLUS ACCOUNTS; SOURCES OF DIVIDEND DISTRIBUTIONS; DISBURSEMENT OF DIVIDENDS FROM PAID-IN CAPITAL

As has been indicated, investment trusts and investment companies as a group did not follow any definite demarcation between the functions of earned surplus and capital-surplus accounts, except that the

maturity. Thus it constitutes part of the cost which the issuer must eventually pay for the use of the funds.

Representing additional interest, generally accepted accounting practice permits it to be allocated over the life of the entire issue as a charge to the profit and loss account. The effect of such treatment is to make the annual charges correspond to the real rather than nominal rate of interest for the use of capital. Similar treatment may be accorded expenses incurred in issuing bonds. These expenses relate to the entire period during which the bonds are to be outstanding and accordingly may be allocated ratably over that period. The unamortized balance, though not a true asset, is pursuant to current accounting convention set up as a separate item in the asset or debit column of the balance sheet. (Investors should appreciate that a debit of this nature, although appearing on the asset side of the balance sheet, does not represent tangible or realizable values. Amortization of such an item results in a charge to current income with the result that, if operations are not carried on at a loss, an amount of assets equal to the charge is retained in the business so that in effect a real asset is substituted for the deferred charge. Such charges should equal the amount of the discount at the maturity of the issue.)

An alternative practice which has some support is to charge bond discount and expense directly to *earned* surplus at the time incurred. (See Section 126 of the Uniform System of Accounts for Public Utility Holding Companies, promulgated by this Commission pursuant to Sections 15 and 20 (a) of the Public Utility Holding Company Act of 1935.) This practice, too, recognizes the charges are properly allocable to earnings, although it does not require that current profit and loss statements be charged.

The financial statements filed by Alleghany did not adopt either of the above procedures. Rather, bond discount and expense was charged directly to *paid-in* surplus in 1929 and 1930. This either overstated Alleghany's net income in subsequent years,

amounts which were allocated to surplus out of money or property received upon the issue of capital shares were segregated in capital-surplus or paid-in-surplus accounts.[81] Both earned surplus and capital surplus were used to reflect trading results, whether before or after a write-down of security values had taken place. Investment profits might be found in one surplus account and losses in the other. At times capital surplus absorbed the entire amount of a write-down of securities, although an earned-surplus balance was also available. At other times capital surplus absorbed only that part of a write-down not taken care of by earned-surplus account. When portfolio values were adjusted to the lower of cost or market value at year-ends, the adjustments were made through capital surplus by some companies and through earned surplus by other companies. Upon the creation of portfolio reserves, the burden fell on earned surplus among some of the trusts, while in the case of others the burden was on capital-surplus account. Charges and credits arising from the sale and retirement of reacquired stock could be found in earned surplus as well as in capital surplus. This was true also as to the excess of face value over cost of reacquired bonds and debentures. Unamortized-debt discount and expense applicable to reacquired securities was adjusted by a number of companies through earned surplus, and by others through capital surplus. Some companies wrote off organization expenses against earned surplus, while others did this in capital-surplus account. The extent to which items of like character appeared in both earned surplus and capital surplus, accounts which are meant to function differently, has already been discussed.

The most recurrent item in capital-surplus account was the amount representing that part of the consideration received which had been allocated to surplus upon the issue of capital stock. Of the 62 closed-end companies studied, 45 apportioned between capital-stock account and capital-surplus account the consideration received upon the issue of stock.[82] Of the 14 open-end companies examined, 3 were not

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by relieving income of charges which would otherwise have been made thereto, or resulted in an overstatement of earned surplus.

In *A Statement of Accounting Principles,* prepared by Messrs. Sanders, Hatfield and Moore, it is stated (p. 78, et seq.):

In exceptional cases it is permissible to amortize the entire amount of bond discount and expense in advance, or at a rate faster than the regular periodic amortization, provided the extra amortization is effected by charges to earned surplus. Examples of such special cases arise when the amount of discount is quite small relative to total assets, or when it begins to appear that the bonds are likely to be retired before maturity. In general such practice should not be resorted to unless substantial grounds exist for it.

It is objectionable to write off such balances against capital surplus, since that proceeding relieves later income accounts and earned-surplus accounts of charges which properly should be made against them. It is still more objectionable to amortize these balances against capital surplus by devices which fail to disclose the full character of the proceeding.

[81] This subject is discussed in detail infra.

[82] The general practice of closed-end companies was to record only the net proceeds received, that is, net after selling fees. The effect of this procedure was that the amount of the financing cost was not recorded in the book account and was not revealed in published reports.

In a few instances the selling cost was charged to surplus, but the item was carried in both earned surplus and capital surplus, as seen in the instances which follow:

Blue Ridge Corporation charged to capital surplus an amount of $541,962 representing "compensation paid to agent on sales of own capital stock in 1929."

Central States Electric Corporation charged to earned surplus an amount of $1,649,916 representing "commission and discount" on the issue of preferred stocks in 1928 and 1929.

Petroleum Corporation of America charged to capital surplus an amount of $9,750,000 designated as underwriting commission.

incorporated bodies, but among the remaining 11, 10 designated as capital surplus a portion of the consideration received for capital stock.

The proportion of paid-in capital allocated to capital-surplus account varied with each company. In particular instances less than 1% was entered in capital-stock account, and thus more than 99% was recorded in capital-surplus account. This unusual result occurred where stock was issued for a price which had no relation to its par value. For example, in Maryland Fund, Inc., an open-end company, the par value of its capital stock, during the period reviewed, was 10 cents per share, but the shares were disposed of in 1935, the last year examined, in the approximate price range of $15 to $17. At the year-end 1935, the amount in capital-stock account was $28,020, but the sum in paid-in surplus account was $4,356,178.[83] Similarly, in Group Securities, Inc., an open-end company, the par value of all classes of capital stock was only 1 cent, although issued at substantial prices above par. As at December 31, 1935, the aggregate amount shown in capital stock account for all classes of capital stock outstanding was $45,201, whereas the balance in paid-in surplus account was $3,885,004.

Typical of cases among closed-end companies issuing no-par value stock was that of The Lehman Corporation. One-half of the $100,000,000 proceeds received in 1929 from the original sale of capital stock, or $50,000,000, was allocated to capital-surplus account. Later, in 1931, an additional amount of $37,759,500 was transferred to capital surplus, carrying the total to $87,759,500, following which only $5 of $100 paid in for each share remained in capital-stock account. This $37,759,500 addition to paid-in surplus account arose out of a reduction in 1931 of the amount in capital-stock account to $5 per share from $50 per share with respect to 839,100 shares then outstanding.[84]

This procedure of increasing the balance of capital surplus, or replenishing capital surplus, or creating capital surplus through a reduction of the amount in capital-stock account generally prevailed among investment companies. This practice was utilized by 46 of the 62 closed-end companies studied, and by 4 of the 11 open-end companies reviewed.

Generally, the purpose of the reduction of capital-stock account was to provide surplus sufficient to absorb a deficit arising from a presently existing depreciation of the value of investments, or from realized losses, or to provide for other eventualities. The writing down of the value of the portfolio from a former level of high prices, the reduction of the carrying value of securities to the lower of cost of market at year-ends, and the establishment of reserves to provide for unrealized depreciation, were accomplished with the assistance of surplus created from a reduction of capital stock.[85]

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[83] See discussion of this company's dividend policy, infra, pp. 2046–47.

[84] See discussion of this company's dividend record hereinafter in this section.

[85] In *A Statement of Accounting Principles* (1938), prepared by Messrs. Sanders, Hatfield, and Moore, and published by American Institute of Accountants, the following is said with respect to surplus from reduction of capital stock (pp. 96–7):

> Assuming that a reduction of capital stock is legally authorized, the surplus created by the reduction is virtually paid-in surplus. Thus, in case a corporation with $100,000 fully-paid capital stock reduces its capital stock to $50,000, the situation is that the stockholders have contributed $100,000; that they hold only $50,000 par-value stock; and, assuming there is no shrinkage in the assets, there is a surplus according to the definition given above of $50,000. It is clear that this surplus was paid in by the stockholders and should be looked upon as any other paid-in surplus. What items may be charged against this depends upon the statutes under which the corporation

In a number of instances the absorption of write-downs and of unrealized and realized losses by surplus arising from a reduction of capital stock made possible a continuation or resumption of dividend payments.[86] In cases of companies incorporated in Delaware and in other states having similar corporation statutes, the reduction of capital stock to create surplus was a device of particular usefulness in overcoming the restrictions in the corporation laws which relate to the payment of dividends.

As stated elsewhere in this report:[87]

The corporation laws of many states purport to protect the "capital" of the company from distribution as dividends,[88] but the "capital" which is thus protected is not the entire consideration received by the company for the sale of its securities, but only that part of the consideration received which may have been designated by the management as "capital" in accordance with provisions of state statutes that permit the creation of "stated capital" and "paid-in surplus."[89] The par value stock is often sold at a so-called "premium" or at a price above the par value of the stock and the excess is treated as paid-in surplus. In the case of no par-value stock most corporation statutes permit the directors of a corporation, in their discretion, to allocate a portion of the contribution received for such stock to paid-in surplus.[90] In general the directors may declare dividends out of such paid-in surplus. Investment companies in the great majority of cases have been incorporated in states permitting the allocation of a portion of contributed capital to paid-in surplus and

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was organized. Subject to varying restrictions for the protection of creditors, the statutes allow surplus arising from a reduction of capital stock to be charged off by distributions of an equivalent amount of assets to the stockholders. A few corporation acts provide that a surplus resulting from reduction of capital stock may be written off against a deficit arising from losses or diminution in the value of assets.

[86] This connection between the reduction of capital stock account and write-downs and payment of dividends is indicated in Appendix L, Schedule 2.

[87] See Ch. V of this part of the report, pp. 1710–22.

[88] "The directors of every corporation created under this Chapter, subject to any restrictions contained in its Certificate of Incorporation, shall have power to declare and pay dividends upon the shares of its capital stock either (a) out of its net assets in excess of its capital as computed in accordance with the provisions of Sections 14, 26, 27 and 28 of this Chapter, or (b) in case there shall be no such excess, out of its net profits for the fiscal year then current and/or the preceding fiscal year; provided, however, that if the capital of the corporation computed as aforesaid shall have been diminished by depreciation in the value of its property, or by losses, or otherwise, to an amount less than the aggregate amount of the capital represented by the issued and outstanding stock of all classes having a preference upon the distribution of assets, the directors of each corporation shall not declare and pay out of such net profits any dividends upon any shares of any classes of its capital stock until the deficiency in the amount of the capital represented by the issued and outstanding stock of all classes having a preference upon the distribution of assets shall have been repaired." (Del. Rev. Code, 1935, Ch. 65, § 34.)

[89] Thus the Delaware corporation law authorizes the payment of dividends (1) from net assets in excess of management-allocated "capital" or (2) from the net profits of the current or preceding fiscal year, provided that the net assets are not less than the aggregate amount of "capital" allocated by the directors to all classes of securities having a preference upon the distribution of the corporation's assets. (Del. Rev. Code, 1935, Ch. 65, § 34.)

[90] Any corporation may by resolution of its Board of Directors determine that only a part of the consideration which shall be received by the corporation for any of the shares of its capital stock which it shall issue from time to time shall be capital; provided, however, that, in case any of the shares issued shall be shares having par value, the amount of the part of such consideration so determined to be capital shall be in excess of the aggregate par value of the shares issued for such consideration having a par value, unless all the shares issued shall be shares having a par value, in which case the amount of the part of such consideration so determined to be capital need be only equal to the aggregate par value of such shares. In each such case the Board of Directors shall specify in dollars the part of such consideration which shall be capital." (Del. Rev. Code, 1935, Ch. 65, § 14.)

the payment of dividends therefrom.[91] Whenever the directors are empowered to designate a part of the capital contributed by the preferred stockholders, as well as that contributed by the common stockholders, as such paid-in surplus, the management is in a position to return to common stockholders as dividends part of the capital invested by them in the company and, should it desire, to go so far as to distribute to common stockholders part of the consideration paid into the company by the preferred stockholders.[92] Thus at the very inception of the securities investment company, the management when it has this power of allocation to paid-in surplus is in a position to expose the actually contributed capital of the company to impairment through the distribution of part of such a paid-in surplus as dividends on the common stock or as dividends on a junior preferred stock.[93]

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[91] A survey of the states of incorporation of management investment companies known to the Commission to have been in existence at some time in the period from 1927 to 1935 reveals that out of 740 such investment companies, 636 were incorporated under the laws of Delaware, New York, Maryland and Massachusetts. Almost half of the entire number—377 of the companies—had been created under the laws of the State of Delaware. The payment of dividends out of paid-in surplus is permitted in these states. (Delaware Corporation Law, §§ 14, 34; New York Stock Corporation Law, §§ 12, 13, 58; Maryland, Bagby's Anno. Code, 1924, and Flack's 1935 Supp., §§ 39, 87; Massachusetts General Laws, 1932, c. 156, §§ 15, 35.)

[92] The following hypothetical case illustrates the possibilities under the Delaware statute: The directors of an investment company which has received $5,000,000 for nopar preferred stock entitled to a total of $5,000,000 on liquidation, and $1,000,000 for common stock designates the $1,000,000 received for the common stock and $2,500,000 of the $5,000,000 received for the preferred stock as capital and $2,500,000 of the amount received for preferred stock as paid-in surplus. Under the terms of the statute the $2,500,000 is "paid-in surplus" available for the payment of dividends to the holders of the common stock. Moreover, if the net assets of the company depreciated to $4,000,000—to a point insufficient to cover the liquidating value of the preferred stock—the company could nonetheless still pay dividends on the common stock because its net assets of $4,000,000 would exceed its statutory "capital" of $3,500,000. In this respect, Professor E. Merrick Dodd, of Harvard Law School, testified as follows at the hearings on April 23, 1940, before a subcommittee of the Senate Committee on Banking and Currency on a bill to provide for the registration and regulation of investment companies and investment advisers:

> * * * Our state laws, notably * * * Delaware law, are extremely lax with regard to dividends. In Delaware, dividends may be paid out of any kind of surplus, and that means that the directors of a Delaware corporation, without consulting the stockholders, may label a large part of the stockholders' original contribution as surplus and then later on ladle that out in dividends. That may be done without warning the stockholders at the time when they are getting the dividends that they are unearned. Since dividends in American corporate practice have normally come out of earnings, the investor normally assumes that that is what he is getting. He thinks he is getting income, but it may be merely a return of his principal, and yet under Delaware law, you don't have to tell him that it is a return of his principal.
>
> That is a state bad enough where you have got only one class of stock, but it becomes much worse where you have two or more classes. At least, if the Delaware law means, and if it would be interpreted by the Delaware courts to mean what it seems to say, there is nothing in that law that would prevent the use of surplus paid in by the preferred shareholders, by the senior security holders, to pay dividends on junior securities. There is nothing in that law, if it means what it seems to say, to prevent paying dividends to common shareholders out of the so-called paid-in surplus, even though the remaining assets are substantially less than the amount which has been promised to the preferred stockholders as a preferential claim in liquidation.
>
> In other words, you may issue stock, preferred stock, with ten-dollar par, or ten-dollar stated value with no par, with the liquidation preference of a hundred dollars; you may issue that stock for a hundred dollars if you can get people to pay that much for it, and then if Delaware law means what most lawyers think it means, and what literally it seems to mean, you can use that $90 paid in by the preferred stockholder to pay dividend on the common stock, in spite of the fact that by doing so, you make a mockery of the preferred stockholders' preferential liquidation.

[93] The payment of dividends to the senior preferred stock out of such "paid-in surplus" is also an impairment of the contributed capital but since that preferred stock is itself the recipient of the capital assets in the form of dividends such distribution at least returns capital to those who contributed it, although by diminishing capital it will tend to diminish the earning power of the corporation and hence its ability to earn and pay future dividends. The return of capital in this form may be used to prevent the working of contingent voting rights of preferred shares.

Analyses of surplus accounts of particular companies were made to ascertain the composition of the accounts to which dividends were charged. In a number of instances capital surplus accounts were charged for dividend distributions, which were the source of these payments. In other cases a part of dividend payments was charged to earned surplus, and another part to capital surplus. In another case, operating deficits were transferred from earned surplus to capital surplus. By relieving earned surplus of deficits, dividends ostensibly could be distributed out of earned surplus account.

Capital surplus accounts were created or increased to offset realized and unrealized losses in investment accounts while dividends were being distributed regularly out of accumulated net ordinary income. This accumulated net ordinary income was comprised of dividends and interest on portfolio securities less current operating expenses but without deduction for any losses on securities, realized or unrealized. In these instances, capital surplus stood between earned surplus and capital stock account to prevent capital stock account from becoming impaired by a deficit arising from realized and unrealized investment losses.

While some companies followed the policy of limiting the amount of distributions to the amount of net ordinary income, other companies did not exclude investment profits as a source for distributions. One company tapped as a source for dividend distributions not only realized but even unrealized profits. These distributions were made out of the capital surplus account:

> It is the present policy to make disbursements from capital surplus only to the extent that there is an unrealized profit equal to or greater than the amount of such disbursement.[94]

In other instances dividend payments were not interrupted although ordinary income was insufficient to cover dividend distributions and were distributed in the face of substantial realized and unrealized losses. Capital surplus was utilized to carry on the dividend program, and if the amount in this account was insufficient for the purpose, the capital surplus account was replenished through a reduction of capital stock account. In one instance, as much as 46% of all dividend distributions was paid from sums other than from accumulated earnings. Two open-end companies whose earnings were insufficient for dividend distributions followed the procedure of issuing shares regularly each period as dividends although earnings were insufficient to cover them. These stock dividends were charged to paid-in surplus.

Unincorporated open-end investment organizations generally have no paid-in surplus accounts, since all funds paid in (except for equalization amounts which are described hereinafter) are deposited in capital or "principal" accounts. Nevertheless the absence of paid-in surplus did not prevent the distribution of dividends by these organizations out of net ordinary income where realized and unrealized losses suffered up to that time far exceeded the amount of net ordinary income. This dividend policy was explained by one of the companies upon the grounds that "* * * in case of testamentary and voluntary trusts, it was generally the practice and the law that capital

[94] Reply to the Commission's questionnaire for Quarterly Income Shares, Inc., Pt. V.

gains or losses should not affect the income payable to beneficiaries. Trusts, such as this, with redeemable shares, are essentially only a development on a large scale of fiduciary trusts." In fact, the declaration of trust of one of the open-end funds, makes it mandatory that net ordinary income be distributed "even though the paid-in capital at the time exceeds the net assets." In the case of this particular fund an impairment of capital account as much as 53% existed at a time when dividends were being disbursed. The articles of incorporation of another open-end fund provided for regular quarterly distributions at the rate of 5% per annum "even though they may not be fully covered by dividends, interest or profits, or in such event to reduce the rate." After a disbursement of dividends at 5% for a time, the rate was cut to 2½%. This fund sustained an impairment of capital of 70% without a cessation of dividends.

The analyses of surplus accounts of various companies, together with a review of their dividend records, now follow. Among other things these analyses demonstrate the practice of investment companies, through the availability of capital surplus account, to disburse dividends despite operating deficits and substantial investment losses.

a. Closed-End Organizations

(1) AMERICAN CAPITAL CORPORATION[95]

American Capital Corporation, a Delaware corporation, from its inception in 1928 and through 1935, paid dividends on its prior preferred shares and on its preferred stock in each of these years, except 1932 when it paid dividends only on the prior preferred stock. The company paid dividends on its common stock during 1929 and 1930 only. The dividend distributions on the two classes of preferred stock in 1928, plus the disbursements on all three classes of stock in 1929, aggregated $1,266,961. This disbursement was accomplished without assistance from paid-in capital. However, in 1930 and thereafter, paid-in capital aided the company materially in carrying out its dividend program.

In 1930 the sum of $750,395 was expended as dividends as follows:

On prior preferred stock	$297,821
On preferred stock	352,575
On common stock	99,999
Total dividends	750,395

After this expenditure, and at the end of the 1930 fiscal period, the amount in earned surplus account was $968,281, but at this same time there existed an unrealized depreciation upon portfolio securities to the extent of $4,555,868. The balance in capital surplus account was $3,680,690. Thus, there was available a total surplus of only $4,645,971 to absorb a depreciation of $4,555,868.

The capital surplus account was built up in 1928 to 1930 practically entirely from an apportionment of $3,650,352 from amounts paid in

[95] Other aspects of the dividend policy of this company are discussed in Ch. V of this part of the report, p. 1717.

upon the sales of its capital shares. In 1930, this account was increased by credits of $315,681 arising from the retirement of preferred stock, and decreased by a write-down of $285,343 of an investment. In this manner, a balance of $3,680,690 became available to absorb that large part of the depreciation exceeding the balance in earned surplus account. Without this aid of paid-in funds, dividend payments might have ceased.

The 1930 earned surplus balance of $968,281.85 was transformed into a deficit by the end of 1931, as follows:

Balance, December 31, 1930	$968,281.85
Add—income, exclusive of trading results	301,922.12
Total	1,270,203.97
Deduct—net loss from sales of securities	1,335,204.32
Balance, deficit, December 31, 1931	65,000.35

This deficit of $65,000.35 was shifted to capital surplus account.[96] The balance of capital surplus at the beginning of the year 1931, of $3,680,000, was augmented by a credit arising from a reduction of $3,744,000 in the stated value of the preferred capital stock (as distinguished from the prior preferred stock), and by credits aggregating $719,305 from retirement of preferred shares, to a total of $8,143,995.

This was the character of the account out of which in 1931 there were paid dividends of $232,236 on the prior preferred stock, and $232,613 on the preferred shares. These dividend charges, totaling $464,849, together with the deficit transfer of $65,000, brought the balance of capital surplus account down to $7,614,146. Matched against this balance at the end of the year was the amount of unrealized depreciation of $7,807,150. Paid-in capital, in addition to offsetting unrealized depreciation, absorbed dividend payments and an operating deficit.

This same use of paid-in capital was continued in 1932, when the stated value of common stock was reduced in the amount of $668,820.

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[96] In this connection the Commission issued an opinion in its accounting series, Release No. 16, dated March 16, 1940, relative to the disclosure which should be made in financial statements when a company charges a deficit to capital surplus pursuant to a resolution of the board of directors, but without approval of the stockholders, such action being permissible under the applicable state law. It is stated in this release that:

> As an additional disclosure in situations to which the provisions of this release are applicable it has been the administrative policy of the Commission to require that in the registration statement or other filing containing financial statements first reflecting such action by the directors there be included an explanation of the action taken and an indication of its possible effect on the character of future dividends. As an example of an appropriate disclosure, there may be cited the following paragraph:
>
> "It should be noted that on ____________ by action of the Board of Directors, without action by the stockholders, the company charged off a $______ deficit in earned surplus against its capital surplus. This procedure will permit the company in the future to reflect undistributed earnings subsequent to ____________ as earned surplus, instead of as a reduction of the deficit charged off to capital surplus. One result of this procedure is to permit the distribution, as ordinary dividends, of earned surplus accruing subsequent to ____________, without regard to the deficit charged off to capital surplus. Furthermore, if earnings subsequent to ____________ are less than the deficit written off, distributions thereof may in effect represent distributions of capital or capital surplus."

Additional credits of $189,195 were created by the retirement of preferred stock. These sums carried the balance of capital surplus at the beginning of the year of $7,614,146 up to $8,472,162. Against this sum the following charges, including another transfer of operating deficit, and including dividends paid upon the prior preferred stock, were made:

(1) Write-down of a security in 1932	$524, 589
(2) Net loss for the year 1932	3, 797, 420
(3) Dividend paid in 1932 upon the prior preferred stock	41, 387

stock 41, 387

In this manner the balance of capital surplus account at the end of the year 1932 was reduced to $4,108,766. The unrealized depreciation then existing was $4,125,366.

These conditions in 1932, similar to those in 1931, reveal, first, the background of security losses behind the payment of dividends in 1931 and 1932 of $273,623 on the prior preferred stock, and of $232,-613 on the preferred shares, or a total of $506,236, and, second, paid-in capital as the source of these dividend payments, or, as described by the company, the "excess over stated capital."

Thereafter from 1933 to 1935, dividends of $1,081,019 were disbursed on the prior preferred and preferred stocks from earnings, which as shown below, included investment profits. At the beginning of this period, the balance in capital surplus account, as indicated above, was $4,108,766, while at the 1935 year-end the balance, increased by credits representing excess of proceeds from sales of certain securities after write-downs, and by a credit arising from retirement of preferred stock, was $4,304,615. The existing earned surplus balance in this 1933–1935 period was not sufficient to overcome existing unrealized depreciation. The deficiency, however, was offset only by capital surplus account, as observed in the following tabulation:

Earned surplus	1933	193	1935
Balance, beginning of year		$154, 686. 02	$181, 711. 61
Net ordinary income	$75. 459. 68	89, 407. 19	74, 751. 00
Trading profits	416, 899. 42	388, 319. 14	573, 787. 24
Total	492, 359. 10	632, 412. 35	830, 249. 85
Less dividends:			
Prior preferred	260, 835. 58	143, 350. 74	138, 971. 17
Preferred	76, 837. 50	307, 350. 00	153, 675. 00
Total	337, 673. 08	450, 700. 74	292, 646. 17
Miscellaneous deductions			30, 151. 79
Balance, earned surplus, end of year	154, 686. 02	181, 711. 61	507, 451. 89
Balance, capital surplus, end of year	4, 108, 765. 66	4, 204, 778. 84	4, 304, 615. 57
Total surplus	4, 263, 451. 68	4, 386, 490. 45	4, 812, 067. 46
Unrealized depreciation at year end	3, 468, 078. 37	3, 302, 773. 89	1, 630, 787. 52

(2) MAYFLOWER ASSOCIATES, INC.

Mayflower Associates, Inc., a Delaware corporation organized in 1928, with only common stock outstanding, stated its dividend policy to be as follows: [97]

> Declarant has regularly made a distribution of fifty cents a share quarterly since the first quarter of 1930. This payment has been made although in some years it constituted a reduction of paid-in surplus. Declarant has never segregated profit from the sale of securities from other income in arriving at surplus available for distribution.

Disbursement of dividends began in 1930, when $1,197,755 was disbursed out of earned surplus, which included investment profits. In 1931, dividends paid aggregated $539,096, of which $272,296 was charged to earned surplus, while $266,800 was paid out of capital surplus. In 1932, 1933, and 1934, a deficit balance existed in earned surplus account, arising mainly from realized portfolio losses. Dividends of $491,526, $466,800, and $442,827, respectively, or a total of $1,401,152, were charged off against capital surplus at these year-ends. In 1935, dividends disbursed, aggregating $448,916, again were apportioned between earned surplus, where $112,229 was charged, and capital surplus, to which $336,687 was charged.

In the aggregate, dividends amounting to $2,004,639 were disbursed out of capital surplus account. This account was composed almost entirely of paid-in capital funds totaling $10,403,758. Of this amount, the sum of $2,264,758 was allocated to capital surplus in 1928 and 1929 upon the sale of common stock, and the sum of $8,139,000 was credited to capital surplus upon the reduction of common stock in May 1931.

(3) UTILITY EQUITIES CORPORATION

Utility Equities Corporation, incorporated in Delaware, stated that the payment of certain of its dividends was from paid-in capital funds: [98]

> Declarant has never paid any dividends on its Priority Stock in any fiscal year in excess of its current or accumulated earnings (before deduction of losses on sales of securities and excluding profits from the sale of securities) for that fiscal year, but its books do show that during the year 1933 at the time of the payment of $307,052.37 in dividends on its Priority Stock, it did not have current or accumulated earnings and charged that amount to paid-in surplus.

The beginning and end of this statement of dividend policy are apparently contradictory. The facts are as follows:

The company's capital structure was comprised of a no par value $5.50 prior preferred stock, and of a no par value common stock. The company paid no dividends on its common stock from 1928 to 1935, and paid dividends on its prior preferred shares in each of the years 1929 to 1935. These dividends were charged to earned surplus account, except in the year 1933, when only a small portion, $42,116,

[97] Reply to the Commission's questionnaire for Mayflower Associates, Inc., Pt. V.

[98] Reply to the Commission's questionnaire for Utility Equities Corporation, Pt. V.

of the dividend paid out, was charged to this account, and the remainder, $307,052, was charged to capital surplus.

Capital surplus account was set up in 1928, $990,000 being allocated out of the proceeds received from sales of the original issue of common stock. This amount of paid-in capital in capital surplus account was increased in 1931 by reductions of common capital stock of $8,586,786 and of preferred capital stock of $3,499,059. Since a write-down of its portfolio was to be made, the balance at the time in earned surplus account of $2,260,543 was closed out to capital surplus. These items increased the balance in capital surplus account in 1931 to $15,336,388. The portfolio as at the end of this year was written down $12,793,101. Thus, the balance in the capital surplus account became $2,543,287. In 1932 and 1933, this balance was increased to $2,683,023 by credits aggregating $139,736 arising from retirement of preferred shares. Against this capital surplus balance of $2,683,023, comprised almost entirely of paid-in capital funds, the sum of $307,052 for dividends disbursed in 1933 to prior preferred shareholders was charged.

(4) ELECTRIC SHAREHOLDINGS CORPORATION

Electric Shareholdings Corporation, a Delaware corporation, with capitalization consisting of $6 cumulative preferred and common stock, stated its dividend policy to be as follows: [99]

> * * * all dividends paid in cash and common stock prior to December 31, 1930, on the equity securities of the declarant were paid out of accumulated earnings including profits from the sale of securities.
>
> Dividends paid on the $6 cumulative convertible preferred stock (optional stock dividend series) in 1931 were paid out of accumulated earnings including profits from the sale of securities and all such dividends paid subsequent to 1931 were charged to capital surplus.

Dividends paid on the preferred stock and charged to capital surplus account were as follows:

	In cash	In stock	Total
1932	$487,702	$257	$487,959
1933	451,803	1	451,804
1935	304,485		304,485

In the period 1929 to and including 1931, capital surplus was composed of the following elements:

Paid in on common shares at time of original issue (1929)	$12,500,000	
Less transfer to preferred capital account to increase stated value to $100 (1929)	798,957	
		$11,701,043

[99] Reply to the Commission's questionnaire for Electric Shareholdings Corporation, Pt. V.

Reduction of stated value of common stock:		
1930	$11,874,002	
1931	6,416,749	
		$18,290,751
Total		29,991,794
Add excess of stated value over cost of preferred stock reacquired and retired (1929–31)		1,332,802
Mark-up of certain securities (1929)		500,000
Total		31,824,596
Less write-downs of securities (exclusive of amounts charged to operating surplus):		
1929	5,058,039	
1930	11,746,314	
1931	11,635,155	
		28,439,508
Balance		3,385,088
Add: 1931 excess of proceeds of investments sold over adjusted valuations. Such proceeds were less than original cost. (The excess of $695,555 of valuations over proceeds of investments sold—losses—were carried to operating surplus account)		405,985
Balance, capital surplus, December 31, 1931		3,791,073

This capital surplus balance of $3,791,073 was increased in 1932 to $4,750,838 by an item of $959,765, representing the excess of stated value over cost of preferred shares reacquired and retired in that year. Against this capital surplus account were charged the dividends disbursed to preferred shareholders in 1932 totaling $487,959, reducing the balance in capital surplus to $4,262,879.

In the years to and including 1931, dividends paid had been charged to operating-surplus account. At the end of 1931, the balance remaining in earned-surplus account of $990,000 was utilized to absorb that part of a write-down of securities, totaling $12,625,155. The remainder of $11,635,155 was charged to capital surplus. In 1932, interest, dividend, and miscellaneous income, net after expenses, including adjustments applicable to prior years, totaled $456,942, which was credited to earned-surplus account. This balance was turned into a deficit of $252,388 by losses during 1932 of $32,057 arising from joint account and syndicate activities, and by the losses aggregating $677,273 from the sales of investments, which losses were based upon written-down values as of December 31, 1931. In addition to the said deficit balance of $252,388, there was, at the end of 1932, an unrealized depreciation on portfolio securities of $1,083,612. Such was the background for the charge in 1932 to capital surplus account for dividends of $487,959 paid to preferred shareholders.

In 1933 the net ordinary income of the company was $381,884. Losses in 1933 from joint account and syndicate operations were $14,495, and losses from sales of investments were $350,455, which, together with the

deficit balance at the beginning of the year of $252,388, produced a deficit balance of $235,454 in earned-surplus account at the end of the year 1933. Also, at that time there was an unrealized depreciation of $7,891,198 on portfolio securities. As against the aggregate of this depreciation and the deficit, totaling $8,126,652, the capital surplus account had a balance at the end of 1933 of $4,290,384. The balance of capital surplus at the beginning of the year 1933 was $4,262,879. During the year this account was increased by $478,892, the excess of stated value over cost of preferred stock reacquired and retired, and by $417 the excess of proceeds of investments sold over adjusted values. In 1933, two dividends, aggregating $451,804, were disbursed to the preferred stockholders. Thus, the balance in the capital surplus account at the end of the year 1933 became $4,290,384. Since there was at the end of the year an unrealized depreciation of $7,891,198, as well as a deficit in earned surplus of $235,454, a total of $8,426,652, the impairment in the capital account, on this basis was $3,836,268. At the time, the balance in common capital account was $1,604,632, and that in preferred capital stock account was $14,403,600. This impairment wiped out the common capital stock account of $1,604,632, and made an inroad in preferred capital stock account of $2,231,636. The extent, if any, to which this impairment existed three months earlier, on September 1, when the second and last dividend of the year was paid, is, if course, problematical.

Doubtlessly because of this condition, no dividends were paid in 1934. In 1935 a payment of dividends out of capital surplus was again made. During this year net income was $667,746, including realized trading profits of $8,464. However, there was at the beginning of the year an accumulated deficit of $436,230, which brought the balance of earned surplus down to $231,516, an amount insufficient to cover the $304,485 preferred-stock dividend paid in that year. With respect to capital surplus account, the balance of $4,290,384 at the end of 1933 was increased by credits of $1,954,992, comprising the excess of stated value over cost of preferred shares reacquired and retired in 1934, and of $373,234 in 1935. Also in 1935 there was a credit item of $39.543, the excess of proceeds of investments sold over the adjusted valuations. The total in capital surplus account, therefore, was $6,658,153 in 1935. The charge for dividends paid to preferred stockholders, as stated, was $304,485, reducing the balance to $6,353,668 at the end of 1935. At this date there was no unrealized depreciation, but rather an unrealized appreciation of $1,630,946.

(5) UNITED STATES & FOREIGN SECURITIES CORPORATION

The extent to which the practice of allocating part of paid-in capital funds to capital surplus was expanded is illustrated in the case of United States & Foreign Securities Corporation, a Maryland corporation. This corporation had three classes of stock outstanding: first preferred, second preferred, and common. The holders of the 250,000 shares of first preferred originally had no voting power, except in the event of certain defaults in dividends as provided by an amendment to the charter. The first preferred stock had been sold, together with 250,000 shares of common stock, in the form of allotment certificates, and was held by the general public. The nonvot-

ing second preferred stock, and 75% of the voting common stock, originally were issued to the sponsors, Dillon, Read & Co., for $5,100,000, of which amount $5,000,000 was allocated to second preferred stock and $100,000 was apportioned to 750,000 out of 1,000,000 shares of common stock sold. Of the $5,000,000 received and allocated to the 50,000 shares of second preferred stock, the corporation set up a credit to "General Reserve" of $4,950,000, or 99% of the total.[100]

The company stated its dividend policy to be as follows:[101]

> During the period from January 1, 1927 to December 31, 1935, dividends aggregating $13,800,246.63 were paid, and during such period total dividends and interest received were in excess of the dividends paid. It has been the general practice of the company to make payment of dividends out of current or accumulated earnings.

Not stated, however, is the fact that capital surplus account was charged $341,490 for a dividend paid on the first preferred stock for the first quarter of 1932.

Dividends had been paid on the second preferred stock until November 1, 1931, and discontinued thereafter. No dividends ever were paid on the common stock. The dividends paid on the second preferred stock through 1931, and the dividends paid on the first preferred shares in each of the years under review, 1927 to 1935, were covered by accumulated ordinary income, net after expenses, with the exception of the first preferred stock dividend disbursed in 1932, mentioned above, which was charged to capital surplus.

Under date of April 30, 1932, first preferred shareholders were advised that "in view of the shrinkage in the market value of the Corporation's assets, the Board of Directors has not declared the May 1, 1932, quarterly dividend on the First Preferred Stock." It is evident that, for a time after the close of the first quarter of 1932, the shrinkage in the market value of the portfolio was greater than the combined amount of earned surplus, capital surplus, and general reserve account. It is also evident that, during the first quarter of 1932, whatever margin there was in excess of the amount of shrinkage in market value was in capital surplus account, to which was charged the dividend of $341,490 paid for the first quarter of 1932 on the first preferred stock. At the end of 1931, the unrealized depreciation

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[100] The following provision in the original Certificate of Incorporation describes the purposes for which this reserve might be used:

> The Board of Directors may cause to be set aside as a reserve, which may be designated by them as a "general reserve" any amounts contributed to the corporation for that purpose. Against this reserve may be charged losses incurred at any time through transactions of the corporation in securities, underwritings, or transactions of any other nature, and such reserve may also be used at the discretion of the Board of Directors for distributions upon the first preferred stock of amounts which, together with the amount of dividends theretofore paid thereon, do not exceed a total amount of $6 per share per annum from the date after which dividends thereon became cumulative. Such reserve may at any time be increased by vote of the Board of Directors from funds contributed for that purpose, and such reserve may also be reduced from time to time by the Board of Directors, either for the purposes above specified or by transfer from such reserve to other reserve accounts, or to capital surplus or other capital accounts.

[101] Reply to the Commission's questionnaire for United States & Foreign Securities Corporation, Pt. V.

upon the securities amounted to $13,124,490. As against this depreciation there existed at December 31, 1931 the following balances:

Earned surplus	$9,423,548
General reserve	4,950,000
Capital surplus	341,123
	14,714,671

There was, therefore, only an excess of $1,590,181 of surplus and reserves over unrealized depreciation at the beginning of the year 1932. At the end of the first half of 1932, the unrealized depreciation was $15,815,000 against which there was:

Earned surplus	$9,423,548
General reserve	4,950,000
Capital surplus	414,162
	14,787,710

At the end of 1932, the unrealized depreciation was decreased to $10,861,533, and this amount, as at the end of the other periods, was exceeded by the aggregate amount in general reserve account, capital surplus account, and earned surplus account after the payment of dividends to the shareholders of the first preferred stock. On May 22, 1933, the company informed the stockholders that "your company is again in a position to pay a dividend on its First Preferred Stock."

It is seen above that general reserve account of $4,950,000 which constituted paid-in capital, was an important factor in the treatment or consideration given to unrealized depreciation. The capital surplus account, to which was charged the dividend of $341,490 paid on the first preferred stock for the first quarter of 1932, was composed solely of credits arising from the retirement of preferred stock reacquired. At the beginning of 1932, the balance stood at $341,123. Sometime during the first two quarters of 1932 this sum was augmented by $414,529 of above-described credits.

(6) UNITED STATES & INTERNATIONAL SECURITIES CORPORATION [102]

United States & International Securities Corporation, organized under the laws of the State of Maryland, late in 1928, was sponsored by the United States & Foreign Securities Corporation (the dividend policy of which company was just summarized) and by the sponsor of the latter company, Dillon, Read & Co. The dividend policy of United States & International Securities Corporation was practically the same as that of United States & Foreign Securities Corporation: [103]

> During the period from the date of organization of the company to December 31, 1935, dividends aggregating $3,756,358.58 were paid, and during such period total dividends and interest received were in excess of the dividends paid. It has been the general practice of the company to make payment of dividends out of current or accumulated earnings.

[102] Other aspects of the dividend policy of this company are discussed in Ch. V of this part of the report, pp. 1715–22.

[103] Reply to the Commission's questionnaire for United States & International Securities Corporation, Pt. V.

As in the case of United States & Foreign Securities Corporation, United States & International Securities Corporation made no reference to the dividends paid out by it from capital surplus account to the first preferred shareholders. This occurred in 1930 and 1935, as seen in the following table of dividends paid by the company during the period under review:

	1929	1930	1935
First preferred dividends:			
Charged to earned surplus	$1,061,498		
Charged to capital surplus		$1,705,776	$239,084
Second preferred dividends: Charged to earned surplus	500,000	250,000	None
Total dividends	1,561,498	1,955,776	239,084

No dividends were paid on the common stock.

At organization, 500,000 first preferred stock allotment certificates were disposed of at $100 each to a syndicate organized by Dillon, Read & Co., this price being callable in installments after the initial deposit payment of 25%, or $12,500,000. The company paid $2,000,000 for services to the syndicate formed to purchase and market these certificates. These allotment certificates were comprised of 500,000 shares of preferred stock, together with 500,000 common shares, and 500,000 common stock subscription warrants. Also, at organization, the entire original authorized issue of 100,000 shares of the second preferred stock was taken down by United States & Foreign Securities Corporation, and in consideration therefor 2,000,000 shares of common stock were issued to this company. The full amount paid upon the issue of these shares was $10,000,000, which amount was entered in the capital shares account of the second preferred stock.

The published report for 1929 stated:

Pursuant to action of the stockholders at a special meeting held on December 13, 1929, the authorized Second Preferred Stock of the corporation was increased from 100,000 shares to 150,000 shares, the authorized Common Stock was increased from 3,000,000 shares to 4,250,000 shares, and a Special Reserve [$9,475,000] was created out of the amount paid in to the corporation upon organization and credited to Second Preferred Stock [$10,000,000]. This Special Reserve is available for payment of dividends on the First Preferred Stock.[104]

This 1929 published report revealed also that the dividends of $1,061,497 paid upon the first preferred stock and of $500,000 paid upon the second preferred stock, a total of $1,561,497, were paid out of the net income, including realized profits, for the period from November 1928 to December 31, 1929. After these dividend payments there was a balance in earned surplus account of $30,950.

At the end of 1929 there was an unrealized depreciation of $2,676,670, but this amount was more than offset by the newly-created general

[104] With reference to this special reserve, the charter, as amended at the special meeting of the stockholders, provided that: "Such Special Reserve may be charged with or used to offset the amount of any loss of any nature incurred through any transaction of the Corporation or any diminution in the value of any asset of the Corporation and may be used for the payment of dividends upon the first preferred stock. * * *"

reserve of $9,475,000. However, this was not true at the end of 1930. During the first half of 1930, a dividend aggregating $250,000 was paid to the second preferred shareholders, which dividend was charged to earned surplus, comprising net ordinary income as reduced by realized losses. Capital surplus, on the other hand, was charged with the payments of dividends aggregating $1,705,776 to the first preferred stockholders for the four quarters ended November 1, 1930. Capital surplus account at the end of 1930 totaled $3,504,402, as follows:

Credits arising from retirement of first preferred stock	$2,950,261
Credits arising from default of holders of allotment certificates	554,141
	3,504,402

After deduction for the dividends of $1,705,776 charged to this capital surplus account, the balance at the end of the year was $1,798,626. At the same time, the balance in earned surplus account was $1,195,421. When the special reserve account of $9,475,000 is added to these surplus accounts totaling $2,994,047, the aggregate is $12,469,047. But the unrealized depreciation at the end of 1930 was $14,560,000. Thus, unrealized depreciation exceeded surplus and reserve by $2,090,953. The portion, if any, of this excess of $2,090,953 of unrealized depreciation over surplus and reserve which existed two months earlier, at November 1, 1930, when a dividend was distributed to the first preferred shareholders, is not known.

No other dividends were paid until the latter part of 1935, when dividends aggregating $239,084 were paid to the first preferred stockholders. By the end of 1935 there were accumulated in capital surplus account credits totaling $12,175,150, arising from retirement of first preferred stock, and credits totaling $554,141, arising from default of holders of allotment certificates, which credits aggregated $12,729,291. The deductions from this sum were an item of a transfer of $959,200 in 1934 to first preferred capital stock account to increase the stated value of these shares to $100, and also the dividends aggregating $1,944,860, paid in 1930 and 1935 to the first preferred shareholders. These deductions totaled $2,904,060. The balance in this capital surplus account at the end of 1935, as accounted for above, was $9,825,231. The special reserve account of $9,475,000 was still in existence at December 31, 1935. The aggregate $19,300,231 of capital surplus balance and special reserve account exceeded the then existing deficit of $501,777 in earned surplus account and the then existing unrealized depreciation of $11,491,759.

(7) THE LEHMAN CORPORATION

The Lehman Corporation was incorporated September 1929 in Delaware with only one class of capital stock issued and outstanding. At no time during the period under review was there any funded debt.

The company paid dividends in each of the years 1930 through 1935. With respect to its dividend policy the company stated:[105]

> Throughout this period the practice of the declarant has been to pay dividends in an amount not greater than the net income derived from interest and dividends,

[105] Reply to the Commission's questionnaire for The Lehman Corporation, Pt. V.

etc. after deducting current expenses. The total net income of this character received during this period amounted to $14,149,757.53 [to December 31, 1935], and the total dividends declared amounted to $11,451,970 [to December 31, 1935]. The dividends were paid in part out of capital surplus.

However, no portion of the dividends paid was charged to capital-surplus account. All dividends disbursed were charged to earned-surplus account. This earned-surplus account reflected not only "the net income derived from interest and dividends, etc., after deducting current expenses," from which it was the stated policy of the company to distribute dividends, but the account also reflected, among other amounts, write-offs and profits and losses from the sales of investments and from joint account and syndicate transactions. During the period from 1931 through 1935, there was a deficit balance in earned-surplus account at the end of each of the fiscal years in this period.

Capital surplus of the company, except for a small sum, consisted of paid-in capital funds. Of the $100,000,000 proceeds received in 1929 from the original sale of 1,000,000 shares of capital stock, one-half, or $50,000,000, was allocated to this capital-surplus account. An additional credit of $37,759,500 was entered in 1931 following the reduction of capital-stock account on October 21, 1931, from $50 to $5 per share upon 839,100 outstanding shares. Therefore, of $100,000,000 total paid-in capital, the sum of $87,749,500 had been transferred to capital-surplus account. Against the total of $87,759,500 in capital-surplus account, there were deductions of $1,837,072.50 in 1931, and $4,672,217.50 in 1932, for the excess of cost over stated value of 313,100 capital shares retired.[106] There was an addition of $43,856.50 in 1934 representing the excess of proceeds over cost of treasury shares resold. Thus, the balance at the end of the last fiscal period under review, June 30, 1935, was $81,294,066.50. The balance at this time in capital-stock account was only $3,434,500.

The extent to which the capital-surplus account was a factor in absorbing the amounts of the deficits in earned-surplus account and the amounts of unrealized depreciation existing at each fiscal year-end, while dividends were presumably being disbursed from accumulated net ordinary income, will be observed from Table 44. As an example, it is to be noted that at June 30, 1932, the definit in earned-surplus account and the unrealized depreciation aggregated $52,164,350. To offset this amount, there was a balance in capital-surplus account at the time of $81,250,210.

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[106] Of this number, 160,900 shares were retired in 1931, when $50 was the stated value, or a total stated value of $8,045,000, and 152,200 shares were retired in 1932 after the stated value was reduced from $50 to $5, or a total stated value of $761,000. Thus, the aggregate stated value of the 313,100 shares retired was $8,806,000. Since $6,509,290 represented the excess of cost over $8,806,000, the total cost was $15,315,290, or an average cost of $48.91 per share. This reacquisition cost was $15,994,710, below the original issue price of $31,310,000, at $100 per share, of the 313,100 shares retired. Through 1934 the corporation repurchased a total of 337,300 shares. These reacquired shares, which represented an original cost to investors of approximately $35,000,000, were repurchased by the company at an average discount of approximately 25% below prevailing net asset values and resulted in an estimated profit to the remaining shareholders of over $6,000,000. (See Ch. I of this part of the report, pp. 20–23.)

TABLE 44.—*The Lehman Corporation—Earnings, dividends, unrealized appreciation, or depreciation, and capital surplus for fiscal periods ending June 30, 1930–June 30, 1935*

	Fiscal year ended June 30—			
	1930	1931	1932	1933
Net ordinary income (after current expenses and taxes)	$3,095,620.15	$2,861,023.10	$2,008,858.27	$1,490,303.68
Dividends paid during fiscal year	750,000.00	2,747,625.00	1,988,715.00	1,639,440.00
Accumulated net ordinary income after dividends paid	2,345,620.15	2,459,018.25	2,479,161.52	2,330,025.20
Profits and (losses) from sales of investments, from syndicates, etc., and write-offs	(1,275,672.15)	(9,293,284.94)	(19,172,554.47)	(1,316,685.06)
Earned surplus balance (deficit) at end of period	1,069,948.00	(8,109,938.84)	(27,262,350.04)	(28,728,171.42)
Unrealized appreciation or (depreciation) at end of period	(12,099,000.00)	(18,860,000.00)	(24,902,000.00)	1,475,000.00
Earned surplus balance adjusted by unrealized appreciation or depreciation at end of period	(11,029,052.00)	(26,969,938.84)	(52,164,350.04)	(27,253,171.42)
Capital surplus at end of period	50,000,000.00	48,082,082.50	81,250,210.00	81,250,210.00

	Fiscal year ended June 30—		
	1934	1935	Balance, 1935
Net ordinary income (after current expenses and taxes)	$1,239,819.28	$2,028,924.21	$12,724,548.69
Dividends paid during fiscal year	1,632,240.00	1,804,405.00	10,562,425.00
Accumulated net ordinary income after dividends paid	1,937,604.48	2,162,123.69	2,162,123.69
Profits and (losses) from sales of investments, from syndicates, etc., and write-offs	2,270,076.26	1,097,779.55	(27,690,340.81)
Earned surplus balance (deficit) at end of period	(26,850,515.88)	(25,528,217.12)	(25,528,217.12)
Unrealized appreciation or (depreciation) at end of period	1,005,000.00	5,120,000.00	5,120,000.00
Earned surplus balance adjusted by unrealized appreciation or depreciation at end of period	(25,845,515.88)	(20,408,217.12)	(20,408,217.12)
Capital surplus at end of period	81,256,887.00	81,294,066.50	81,294,066.50

(8) CARRIERS & GENERAL CORPORATION

Carriers & General Corporation was organized in August 1929 in Maryland. During the period under review, the company issued only one class of capital stock, common stock. There was no funded debt outstanding until about the end of the period under review, when, in November 1935, the company sold an issue of 15-year debentures.

This company paid dividends in each year during the period from 1930 to 1935, aggregating $1,090,667. With regard to its dividend policy the company stated:[107]

I. It has been the policy of declarant to pay out in dividends all income received by way of dividends and interest less expenses.

II. Dividends while measured by current earnings as set forth in I hereof, have been charged to capital surplus as there has been no earned surplus.

As indicated, due to the absence of earned surplus, the dividends were charged to capital surplus.

The company's trading losses exceeded interest and dividend income, and a deficit resulted, which was carried to a deficit account. This deficit was increased by the dividend disbursements of $1,090,667. The balances in the deficit account were offset by the balances in capital surplus account, totaling $14,137,623, which consisted of paid-in capital, except for the sum of $374,021. The latter sum represented the excess of stated value over cost of capital stock reacquired and retired, of which sum $327,736 was credited in 1930, $43,013 in 1931, and $3,272 in 1932. That part of capital surplus account which was comprised of paid-in capital consisted of $5,600,000 of excess of proceeds received from sale of capital stock over stated value, and of $8,163,602 which arose from three successive reductions of capital stock account as follows:

1930 From $15 to $10 stated value per share	$3,106,015
1931 From $10 to $5 stated value per share	2,820,215
1932 From $5 to $1 par value per share (net after deduction of $6,800 for 1,700 shares in treasury)	2,237,372

The extent to which this capital surplus account offset deficit account, including dividends paid, and the unrealized depreciation, is seen in Table 45.

The excess of capital surplus over deficit at the end of the years 1930, 1931, and 1932 did not exceed the amounts of the capital-stock reductions in those years. In other words, had it not been for these successive capital-stock-account reductions, there would have been an impairment of capital-stock account. The amount of these reductions, as compared to the excess of capital-surplus account over deficit after dividends paid and unrealized depreciation for these years, was as follows:

Year ended—	Reduction of capital stock account	Excess of capital surplus at year end over deficit of earned surplus after dividends and unrealized depreciation
1930	$3,106,015	$2,918,647
1931	2,820,215	734,471
1932	2,237,372	2,135,980

[107] Reply to the Commission's questionnaire for Carriers & General Corporation, Pt. V.

TABLE 45.—*Carriers & General Corporation—Earnings, dividends, unrealized depreciation and capital surplus for years ending Dec. 31, 1929–Dec. 31, 1935*

	Period ended December 31—			
	1929	1930	1931	1932
Net ordinary income less expenses and taxes	$183,396.21	$516,640.16	$321,513.02	$129,480.74
Dividends paid during year		328,989.00	286,066.77	140,005.75
Accumulated net ordinary income after dividends	183,396.21	371,047.37	406,493.62	395,968.61
Profits and (losses) from sales of investments and from syndicate and joint-account transactions	189,555.64	(1,913,039.65)	(1,168,691.72)	(1,694,287.19)
Earned surplus balance (deficit) after dividends	372,951.85	(1,352,436.64)	(2,485,682.11)	(4,190,494.31)
Unrealized depreciation at end of period	2,405,784.01	4,762,666.98	8,676,825.71	7,811,148.62
Deficit in earned surplus after dividends and unrealized depreciation	2,032,832.16	6,115,103.62	11,162,507.82	12,001,642.93
Capital surplus at end of period	5,600,000.00	9,033,750.80	11,896,978.92	14,137,623.42

	Period ended December 31—			
	1933	1934	1935	Balance, 1935
Net ordinary income less expenses and taxes	$90,977.03	$158,063.70	$125,737.50	$1,525,808.36
Dividends paid during year	111,868.60	111,868.60	111,868.60	1,090,667.32
Accumulated net ordinary income after dividends	375,077.04	421,272.14	435,141.04	435,141.04
Profits and (losses) from sales of investments and from syndicate and joint-account transactions	(2,750,532.73)	(896,953.65)	(355,196.98)	(8,589,146.28)
Earned surplus balance (deficit) after dividends	(6,961,918.61)	(7,812,677.16)	(8,154,005.24)	(8,154,005.24)
Unrealized depreciation at end of period	3,201,335.06	2,314,101.08	1,616,351.52	1,616,351.52
Deficit in earned surplus after dividends and unrealized depreciation	10,163,253.67	10,126,778.24	9,770,356.76	9,770,356.76
Capital surplus at end of period	14,137,623.42	14,137,623.42	14,137,623.42	14,137,623.42

b. Open-End Organizations

Of the 14 open-end trusts reviewed, 11 were corporations and the remaining three were organized as Massachusetts or common law trusts.[108]

Open-end investment companies generally distributed dividends out of an account maintained as a subdivision of surplus, designated by 11 of the 14 companies under review as tabulated below. The other three companies maintained no special distribution accounts.

Name of account	Number of companies
Distribution	5
Income and distribution	1
Undistributed income	4
Undivided earnings	1

These accounts were usually credited with net ordinary income, and usually were exclusive of profits or losses on sales of securities.

(1) EQUALIZATION PAYMENTS

The distribution accounts also were credited and charged with "equalization amounts." The equalization credits represented the sums apportioned from the consideration received from the sales of shares of capital stock to adjust for the proportion of the dividend which accrued on the open-end company shares. The equalization charges represented the amounts apportioned from the redemption price of shares redeemed. It is argued that this procedure was necessary to equalize the share amount of the distribution account applicable to outstanding shares at the time of such sales or redemptions.[109]

Lybrand, Ross Bros. & Montgomery, public accountants, explained the reasons for this method of accounting in a letter to Incorporated Investors, dated August 25, 1936, which read in part as follows:

> This corporation is an open-end investment company. It has been issuing its new shares at prices based on daily "liquidating value" of the company's total net assets. The price changes as the liquidating value changes. One of the factors affecting the price is the accumulation of cash earnings retained among the assets until the company's next dividend date. Therefore, the price of new shares, though based on the value of the total assets, includes

[108] These three were Massachusetts Investors Trust, Investment Trust Fund A, and Investment Trust Fund B. Accounts reflecting the sums paid in by purchasers of certificates of beneficial interest in these funds are reviewed hereinafter with respect to the records of distributions by these organizations.

[109] The Maryland Fund, Inc., in its published reports, described the equalization amount as follows:

> "Portion of net consideration received or receivable for subscriptions to capital stock (less comparable amounts paid out on capital stock reacquired) representing the equalization of the per-share amounts of the distribution account at dates of such subscriptions and reacquisitions."

a participation in accumulated distributable earnings. These participations are paid back to investors in succeeding dividends declared by the company.

The amount of the participation credited to Undivided Earnings account is measured by the ratio of accrued current earnings and the undistributed balance in the Undivided Earnings account to the total "liquidating value" at the date of issue.

Numerous purchases of new shares issued by the company are made at different times between dividend dates. The company's method of accounting properly and equitably adjusts the relative interests of old and new shares in the accumulating earnings pending their distribution. Unless this method of accounting is followed, the holders of certificates representing stock outstanding for the entire interval between dividend dates would not receive the full share of earnings which they are in equity entitled to.

NO ALTERNATIVE PROCEDURE WOULD BE EQUITABLE

The sum which the directors decide to make available for distribution in dividends must be distributed pro rata; as to each share outstanding as of the dividend record date the same dividend must be paid, whether the share has been outstanding for six months, or for a day only, prior to the record date as of which the dividend is declared. If this corporation were not to follow the practice of setting aside a portion of the proceeds of new shares issued as a participation in undivided earnings, an investor for the entire term would receive a lower rate of return than he should have on his investment, for some of the income earned by the company on his capital would in effect be diverted and paid on shares outstanding for only a part of the term. The distributable income fairly due to investors whose capital in the hands of the company has been earning income for the entire term between dividend dates would be unjustly lowered or diluted.

Your company overcomes the inequity inherent in the case just considered. The practice you have followed results in distributing to investors whose investment is earning income for the whole dividend period a just proportion of the earnings undiluted by amounts of earnings and participations distributable to investors who buy certificates representing new shares issued by the company during the period. We know of no method of accounting that would be practicable and at the same time equitable as between new and old holders during periods when new shares are being issued from day to day other than the method which this company has followed.

To illustrate, if a company had a distribution account with a balance equal to 10% of its net worth, 10% of the selling price of new shares sold was credited, and 10% of the redemption price of shares redeemed was charged to the distribution account. Thus, the share amount of the distribution account was not affected by changes in the number of shares outstanding resulting from sales and redemptions. Since sales generally exceeded redemptions, equalization proceeds credited to the distribution account exceeded the equalization payments charged to it. Therefore, the distribution account from which dividends were paid consisted of net ordinary income and contributions from stockholders.

The equalization method is accepted practice by 10 out of the 14 open-end companies under review. Two corporations (State Street

Investment Corporation and Spencer Trask Fund, Inc.) and two of the three common law trusts (Investment Trust Fund A and Investment Trust Fund B) did not follow this practice.

As stated, the allocation to undistributed earnings account of an equalization amount comprised one of several sources for dividend disbursements by open-end companies. As was the case in closed-end organizations realized investment profits augmented ordinary income to make possible payment of dividends by a few open-end companies. So, too, distributions were made from paid-in capital. In several cases dividends were distributed while an impairment of capital stock or "principal" accounts existed.

(2) SOURCES OF PAYMENTS OF DIVIDENDS

Table 46 indicates the amounts disbursed as dividends and the sources of these payments for the 14 open-end companies reviewed. The instances where substantial sums were disbursed from paid-in capital, and where capital stock accounts, or "principal" accounts, were impaired are specifically discussed.

(a) State Street Investment Corporation

State Street Investment Corporation, an open-end investment corporation organized under Massachusetts law, paid, during the period 1927–1935, cash dividends aggregating $4,006,091, of which total $2,174,059 was charged to earned surplus, and $1,832,032, or about 46% of all cash dividends paid, was charged to capital surplus account. Cash dividends totaling $536,999 were distributed in 1931 during which year an impairment of capital stock account existed.

From January 1, 1927 to June 22, 1933, the dividends were paid on the Class A stock, which was the voting stock, and on the Class B stock, each share sharing alike. After June 22, 1933, only one class of stock was outstanding, common stock with no par value.

With reference to its dividend policy, the company stated that capital stock account was reduced early in 1932 to permit a continuance of dividends, and at the same time the right to pay cash dividends from surplus created from reduction of capital stock account was inserted in the company's charter.[110]

> In a general way it has been the policy of the directors of the declarant to pay dividends at a rate which is approximately equal to the rate which the declarant receives on its own investments. With such a policy it is obvious that the declarant's investment income (exclusive of profits from the sale of securities) will rarely be sufficient to entirely cover dividend disbursements and the whole management fee.

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[110] Reply to the Commission's questionnaire for State Street Investment Corporation, Pt. V.

TABLE 46.—*Sources of cash dividend distributions by 14 open-end companies, 1927–35*

Company	Total cash distributions during period under review	Disbursed from paid-in or capital surplus		Disbursed from undistributed income account or its equivalent	Equalization amounts included in earned surplus, or its equivalent
		Amount	Percentage of total disbursement		
Bullock Fund, Ltd	$201,561.36	$16,368.61	8.12	$185,192.75	
Canadian Investment Fund, Ltd	191,583.39	25,865.42	13.50	165,717.97	
Dividend Shares, Inc	3,376,816.44	252,702.88	7.48	3,124,113.56	[a] $252,702.88
Group Securities, Inc	117,829.26	21,009.54	17.83	96,819.72	
Incorporated Investors	6,796,626.35			6,796,626.35	710,062.49
Investment Trust Fund A	[b] 6,233,573.19				
Investment Trust Fund B	None				
Investors Fund C, Inc	195,114.50			195,114.50	5,547.23
Maryland Fund, Inc., The	64,719.80	23,142.77	35.76	41,577.03	
Massachusetts Investors Trust	7,940,258.76			7,940,258.76	470,735.56
Nation-Wide Securities Company	688,358.62	23,141.93	3.36	665,216.69	
Quarterly Income Shares, Inc	6,071,641.36	2,754,995.92	45.37	3,316,645.44	
Spencer Trask Fund, Inc	1,320,334.40			1,320,334.40	
State Street Investment Corporation	4,006,091.20	1,832,031.70	45.73	2,174,059.50	

[a] Included in paid-in surplus.
[b] See discussion of this company in text, infra, p. 2029.

On February 19, 1932, in order to permit a continuance of dividends, stockholders voted to transfer $10,000,000 from Capital to Surplus. At that time there existed a small earned surplus which was subsequently exhausted by losses sustained from sales of securities, in addition to a substantial amount of the $10,000,000 transferred from Capital to Surplus. Since that time and through the quarter ended September 30, 1935, although the asset values in terms of market quotations increased substantially, profits taken and income received were not enough to wipe out this deficit. Thus from the quarter ended June 30, 1932, through the quarter ended September 30, 1935, there was a deficit in the paid-in capital of the declarant due to the fact that net losses realized from sales of securities exceeded net income accumulated since date of organization. Beginning with April 15, 1932 and up to and including October 14, 1935, distributions have been paid out of this surplus created by the vote of stockholders.

This deficit, which on December 31, 1934, amounted to $1,527,373.84, was made up during November, 1935 and there existed as of December 31, 1935, an earned surplus amounting to $1,731,994.42.

The vote of stockholders on February 19, 1932, included the following:

"All surplus of the Corporation including the increase thereof by virtue of the reduction of capital herein provided shall be available at the discretion of the Board of Directors for the general purposes of the Corporation and for all purposes for which cumulative and undivided profits may be used, including the payment of cash or stock dividends."

An analysis of the company's surplus account indicates that interest and dividend income, net after operating expenses, was insufficient, until 1935, to cover dividend distributions. It was necessary to use realized profits, while they existed, for the amounts paid out as

dividends. Realized security profits, as a source for dividends not covered by ordinary income, began to shrink in 1930, and, at the end of 1932, the accumulated losses realized from the sale of securities exceeded previously accumulated surplus. In addition, at the end of each of the years 1930 to 1932, an unrealized loss existed. At the end of 1930, the unrealized loss amounted to $5,089,417, a sum which was $2,722,381 in excess of the amount then in surplus account. At the 1931 year-end, the unrealized depreciation amounted to $7,186,474, and this sum was $6,206,483 in excess of the amount at that time in the company's surplus account. Therefore, capital stock account, which amounted to slightly more than $14,000,000 on the average during 1931, was impaired by $2,722,381 at the beginning of the year, and by $6,206,483 at the end of the year after giving effect to unrealized depreciation.[111] However, a small earned surplus existed at the beginning and end of 1931, but unrealized losses more than offset the small amount in earned surplus account.

In order to permit a continuance of dividends, the stockholders voted in February 1932 to reduce capital stock account by the sum of $10,000,000, from which $1,915,790 was deducted as applicable to treasury stock then held, and the balance of $8,084,210 was transferred to surplus account. This sum offset the existing deficit. Thereafter, dividends were paid from sources other than from accumulated net earnings. These dividends paid, in the period 1932 to and including 1935, aggregated $1,832,031, or approximately 46% of all cash dividends paid in the period under review.

The disbursement of these dividends, their sources, and the impairment of capital stock account, at the beginning and end of 1931, are indicated in the analysis of the company's surplus account (Table 47). A 100% stock dividend was paid on January 15, 1929, to stockholders of record December 31, 1928, and charged to surplus account in the amount of $63,186.[112]

(b) Quarterly Income Shares, Inc.

Quarterly Income Shares, Inc., an open-end company incorporated under the laws of the State of Maryland, stated with respect to its dividend policy:[113]

> During the period from date of incorporation of Declarant, December 9, 1932, to April 15, 1934, it was the policy of the Declarant to make quarterly distributions to its stockholders of 3 cents a share. These distributions were derived from cash dividend income and accumulated funds received on trust shares liquidated, plus appropriations from net profits from sales of securities sufficient to make available a total distribution of 3 cents per share per quarter. During the period from April 15, 1934, to December 31, 1935, the corporation's policy has been to continue its quarterly distributions of 3 cents a share to stockholders, but during this period, because of the increasing corporation income taxes, it refrained as much as possible from realizing profits

[111] State Street Investment Corporation was one of the few investment trusts which, until it reduced capital stock account on February 19, 1932, did not allocate to paid-in surplus account any portion of the proceeds received from sales of capital stock.

[112] This dividend is specifically discussed hereinafter in connection with a discussion of stock split-ups and stock dividends.

[113] Reply to the Commission's questionnaire for Quarterly Income Shares, Inc., Pt. V.

from sales of securities and appropriated from paid-in surplus sufficient amounts each quarter to add to its net income from investments to make available such quarterly distributions. For the three months ending April 15, 1935, the distribution was paid from Net Income, Paid-In Surplus and appropriations from net profits from sales of securities. At time of last distribution (February 1, 1936), made partially from capital surplus, there existed an unrealized appreciation of $8,803,599.21 compared to withdrawal of $369,249.02 from capital surplus. It is the present policy to make disbursements from capital surplus only to the extent that there is an unrealized profit equal to or greater than the amount of such disbursement.

TABLE 47.—*State Street Investment Corporation—Analysis of surplus account, 1924–35*

	Year ended Dec. 31—					
	1924–26	1927	1928	1929	1930	1931
Net ordinary income after operating expenses	$62, 155. 53	$42, 103. 77	$23, 542. 66	$240, 230. 13	$451, 950. 13	$342, 273. 42
Cash dividends declared from accumulated net earnings [a]		250, 000. 00		447, 517. 75	570, 500. 25	536, 999. 25
Balance (deficit) of net ordinary income after dividends from net earnings	62, 155. 53	(145, 740. 70)	(122, 198. 04)	(329, 485. 66)	(448, 035. 78)	(642, 761. 61)
Profits, less taxes thereon, and (losses) upon sales of securities		319, 314. 34	1, 436, 455. 08	2, 942, 274. 99	(1, 652, 989. 40)	(1, 305, 148. 23)
Miscellaneous and credit adjustments		(7, 936. 46)	(6, 521. 63)	[b] (24, 827. 98)	(2, 064. 78)	4, 463. 24
Earned surplus balance (deficit)	62, 155. 53	165, 637. 18	1, 619, 113. 29	4, 329, 272. 68	2, 555, 668. 38	1, 060, 257. 56
Net (charges) and credits arising from purchases and sales of treasury stock [3]				(289, 473. 67)	100, 841. 38	108, 365. 43
Combined surplus balance at end of period per books	62, 155. 53	165, 637. 18	1, 619, 113. 29	4, 039, 799. 01	2, 367, 036. 09	979, 990. 70
Unrealized appreciation less taxes thereon or unrealized (depreciation) at end of period		678, 313. 46	3, 758, 004. 32	(2, 493, 491. 39)	(5, 089, 417. 71)	(7, 186, 474. 20)
Combined surplus balance (deficit) at end of period after giving effect to unrealized appreciation or depreciation		843, 950. 64	5, 377, 117. 61	1, 546, 307. 62	(2, 722, 381. 62)	(6, 206, 483. 50)

See footnotes at end of table.

TABLE 47.—*State Street Investment Corporation—Analysis of surplus account, 1924–35*—Continued

	Year ended Dec. 31—				
	1932	1933	1934	1935	Balance, 1935
Net ordinary income after operating expenses	$277, 164. 93	$221, 065. 26	$483, 941. 71	$724, 809. 00	$2, 869, 236. 54
Cash dividends declared from accumulated net earnings [a]	130, 584. 75			238, 457. 50	2, 174, 059. 50
Balance (deficit) of net ordinary income after dividends from net earnings	(496, 181. 43)	(275, 116. 17)	208, 825. 54	695, 177. 04	695, 177. 04
Profits, less taxes thereon, and (losses) upon sales of securities	(3, 621, 326. 70)	(8, 368. 86)	122, 005. 01	2, 834, 975. 06	1, 067, 191. 29
Miscellaneous and credit adjustments	31. 22		5, 254. 78	1, 227. 70	(30, 373. 91)
Earned surplus balance (deficit)	(2, 414, 457. 74)	(2, 201, 761. 34)	(1, 590, 559. 84)	1, 731, 994. 42	1, 731, 994. 42
Credit arising from reduction in capital stock	8, 084, 210. 49				8, 084, 210. 49
Net (charges) and credits arising from purchases and sales of treasury stock [c]	131, 397. 23	861, 559. 80	(14, 612. 62)	4, 503. 22	902, 620. 77
Cash dividends paid other than from accumulated net earnings	258, 932. 50	396, 987. 20	620, 300. 40	555, 811. 60	1, 832, 031. 70
Combined surplus balance at end of period per books	5, 461, 950. 62	6, 139, 259. 62	6, 115, 548. 10	8, 886, 793. 98	8, 886, 793. 98
Unrealized appreciation less taxes thereon or unrealized (depreciation) at end of period	(3, 770, 218. 62)	869, 747. 76	1, 006, 904. 34	9, 413, 435. 34	9, 413, 435. 34
Combined surplus balance (deficit) at end of period after giving effect to unrealized appreciation or depreciation	1, 691, 732. 00	7, 009, 007. 38	7, 122, 452. 44	18, 300, 229. 32	18, 300, 229. 32

[a] See also cash dividends charged to capital surplus (1932-1935) and stock dividend charged to earned surplus (1929).

[b] Includes stock dividend paid, $63,186.

[c] The net charges or credits to surplus, arising from purchases and sales of treasury stock prior to February 19, 1932, represent the net result of combining (a) the adjustments of the cost of treasury stock reacquired to average paid-in value and (b) the difference between the average paid-in value of stock reissued and the net proceeds thereof. Subsequent to February 19, 1932, the adjustments were to the revised capital value per share (as a result of the $10,000,000 reduction voted on that date) in place of average original paid-in value.

During the period from December 9, 1932, to October 15, 1935, the company distributed dividends aggregating $6,071,641, which were reflected in three different surplus accounts. The sum of $3,316,645 was charged to earned surplus account comprising net ordinary income and also profits upon sales of securities; $1,632,667 distributed was charged to paid-in surplus account; and $1,122,329 was charged to a so-called reserve account. In this reserve account were accumulated the equalization amounts after having been transferred out of paid-in and capital surplus account. Thus, of the total amount of $6,071,641 distributed as dividends, the sum of $2,754,996, or 45%, was charged to paid-in capital funds. The company distributed not only the net ordinary income but almost the entire amount realized as profits on sales of securities (Table 48).

The company stated:

> * * * because of the increasing corporation income taxes, it refrained as much as possible from realizing profits from sales of securities and appropriated from paid-in surplus sufficient amounts each quarter [April 15, 1934, to December 31, 1935] to add to its net income from investments to make available such quarterly distributions * * * It is the present policy to make disbursements from capital surplus only to the extent that there is an unrealized profit equal to or greater than the amount of such disbursement.

Such a dividend policy presents various problems. The unrealized profits which the company intentionally distributes may become losses when the securities are sold. Moreover, as long as the securities have not been sold, the unrealized appreciation thereon at the beginning of the period may change to an unrealized loss at the end of the period. This actually did occur in the company's experience. Furthermore, when unrealized profits are paid out as dividends at the end of one quarter from paid-in surplus account, a duplicating second dividend may be paid in the subsequent quarters from earned surplus account, if the unrealized profits are realized and carried to the earned surplus account. Such distributions probably were made for the company disbursed as dividends almost the entire amount realized as security profits, and some portion of this amount might have represented previously existing unrealized appreciation which had been paid out in part as dividends from paid-in surplus account.

The unrealized appreciation or depreciation existing at the end of each period was as follows:

October 15, 1933, appreciation	$933,046
October 15, 1934, depreciation	1,493,580
October 15, 1935, appreciation	6,545,677

TABLE 48.—*Quarterly Income Shares, Inc.—Analysis of earned surplus, paid-in and capital surplus, and reserve, 1932–35*

	Dec. 9, 1932, to Dec. 31, 1932	Jan. 1, 1933, to Oct. 15, 1933	Year ended Oct. 15, 1934	Year ended Oct. 15, 1935	Balance, Oct. 15, 1935
I. Analysis of earned surplus:					
Net income derived from interest and dividends after operating expenses	$510.00	$174, 275. 04	$819, 330. 00	$1, 182, 772. 21	$2, 176, 887. 25
Amount included in dividend distribution	----------	350, 043. 80	1, 346, 536. 82	1, 620, 064. 82	3, 316, 645. 44
Balance	510. 00	(175, 258. 76)	(702, 465. 58)	(1, 139, 758. 19)	(1, 139, 758. 19)
Profits upon sales of securities	----------	236, 180. 58	750, 288. 28	159, 495. 12	1, 145, 963. 98
Other income items	----------	68, 912. 79	81, 347. 65	22, 253. 39	172, 513. 83
Taxes	----------	25, 798. 33	86, 506. 66	(14, 094. 10)	98, 210. 89
Balance at end of period	510. 00	104, 036. 28	321, 958. 73	80, 508. 73	80, 508. 73
II. Analysis of paid-in and capital surplus:					
Excess over par value of net consideration received	85, 230. 68	10, 981, 370. 27	11, 726, 289. 61	3, 081, 808. 22	25, 874, 698. 78
Miscellaneous credits	----------	100, 042. 46	104, 536. 13	23, 773. 05	228, 351. 64
Amount allocated to reserve (see below)	111. 54	547, 116. 66	543, 445. 95	26, 655. 20	1, 117, 329. 35
Amount included in dividend distributions	----------	373, 554. 80	279, 116. 69	979, 995. 08	1, 632. 666. 57
Balance at end of period	85, 119. 14	10, 245, 860. 41	21, 254, 123. 51	23, 353, 054. 50	23, 353, 054. 50
III. Analysis of reserve:					
Portions of amounts paid in by subscribers to capital stock allocated to reserve to equalize the per-share amounts thereof, less amounts paid out upon reacquisitions	111. 54	547, 116. 66	543, 445. 95	26, 655. 20	1, 117, 329. 35
Miscellaneous credit items	4, 312. 50	687. 50	--------------	--------------	5, 000. 00
Amount included in dividend distributions	----------	--------------	717, 421. 22	404, 908. 13	1, 122, 329. 35
Balance at end of period	4, 424. 04	552, 228. 20	378, 252. 93	--------------	--------------

(c) Massachusetts Investors Trust

The capital funds of Massachusetts Investors Trust, organized in 1924 under an indenture of trust, in the Commonwealth of Massachusetts, were reflected in a so-called "principal" account. This account was credited with the entire proceeds from sales of shares, and was charged with the cost of shares reacquired, exclusive, however, of the equalization amounts which were reflected in undistributed income account. There were no paid-in surplus or capital surplus accounts. The only surplus accounts maintained were the Accumulated Surplus account and Undistributed Income account. The Accumulated Surplus account reflected the profits and losses on sales of se-

curities, and taxes applicable to security profits. To this account was charged a special dividend paid in 1928 of $95,095. The Undistributed Income account carried net ordinary income, as well as equalization amounts, and it was from this account that the regular cash dividends were disbursed.

With respect to this trust's dividend policy, distributions must be made "even though the paid-in capital at the time exceeds the net assets." For the period from 1930 through 1934, dividends were paid while "principal" account was impaired after giving effect to unrealized depreciation. The trust stated: [114]

The Trust is required to distribute each year out of its available assets, an amount measured approximately by the net income of the Trust in the calendar year adjusted for amounts included as accrued dividend in the price of shares issued or repurchased during the calendar year. The Trust must make such distributions even though the paid-in capital at the time exceeds the net assets, based either on market or book value. The Trust also has the right to make distributions in shares, but it is the present policy to make only cash distributions.

"Net Income" is defined as gross earnings, excluding gains on sales of securities, less expenses including taxes, commissions to the Trustees, and other charges properly deductible for the maintenance and administration of the Trust; but there shall not be deducted from gross or net income any losses on securities, realized or unrealized. The Trustees have discretion to determine which items shall be treated as earnings and which as principal, but they must treat as principal stock dividends received, except when companies have established the practice of paying stock dividends not exceeding ten percent (10%) per annum in lieu of or in addition to cash dividends, in which cases the Trustees may in their discretion treat such stock dividends as earnings.

On May 22, 1928, the Trustees declared a special dividend of $1.00 per share (equivalent to 50¢ per share on the present $1.00 par value shares) from capital surplus. In the annual report for 1928 the Trustees announced that instead of paying any extra dividend from capital gains they would pay stock dividends semiannually of 1%. Such stock dividends were paid semiannually until March 1932. Share distributions were discontinued thereafter as they did not affect the value of the shareholders' interest in the Trust, and the expense connected therewith was constantly increasing.

The reasons why declarant does not distribute capital gains in years in which it has such gains, and why the Indenture was drawn with this in mind are: First, that such gains are non-recurrent and the persons who invest in the shares might be grossly misled as to the real value of their shares if such a policy were followed. Second, if such a policy were followed in years in which gains were realized, it would necessarily be incumbent on the management to follow the same policy in years in which losses were sustained, and this would result in the shareholders receiving nothing in years when losses wiped out current income. In this latter connection, if declarant paid out gains in good years, an unavoidable shrinkage in its principal would result in bad years when it suffered losses as it would not be able to make up such losses in subsequent years. We believe the policy of declarant in consistently disregarding capital gains and losses in determining distributions to its shareholders is sound economically, and in correspondence with the Commissioner

[114] Reply to the Commission's questionnaire for Massachusetts Investors Trust, Pt. V.

of Internal Revenue, declarant has stated that it believes that this policy is consistent with what the Securities & Exchange Commission deems as the better accounting practice for investment trusts such as declarant. Incidentally, in case of testamentary and voluntary trusts, it was generally the practice and the law that capital gains or losses should not affect the income payable to beneficiaries and trusts such as this, with redeemable shares, are essentially only a development on a large scale of fiduciary trusts.

Table 49 indicates the dividends paid from net ordinary income and equalization amounts and it is evident that, except for small amounts, this ordinary income and the equalization amounts were distributed in full. The equalization amounts aggregated $470,735, which comprised almost 6% of the $7,845,163 distributed. Table 49 also tabulates the profits and losses from the sale of securities, and indicates a record of profits through 1929 with a dividend disbursed out of this account in 1928. However, the record for the period 1930 through 1934 was one of losses, which accounts for the impairment of "principal" shown in Table 49, which recapitulates also the surplus and deficit accounts of the company, and indicates the unrealized appreciation or depreciation at the end of each period. If effect be given to unrealized depreciation, Table 49 reveals that there was an impairment of "principal" account at the end of each year 1930 to and including 1934 to the following extent:

As at Dec. 31—	"Principal" paid-in	Amount of impairment of "principal"	Percent of impairment
1930	$19,395,371	$4,305,445	22
1931	28,133,154	14,055,211	50
1932	29,072,800	15,532,754	53
1933	32,741,731	11,740,444	35
1934	40,930,281	10,120,633	25

During the years 1931 to 1934, when "principal" clearly was impaired if unrealized depreciation be taken into account, the following cash dividends, aggregating $3,741,077, were paid:

1931	$942,620
1932	795,737
1933	859,449
1934	1,143,271

It must be noted that this common-law trust, unlike a corporation, had no paid-in surplus account or surplus created by reduction of capital-stock account to offset unrealized depreciation.

TABLE 49.—*Massachusetts Investors Trust—Net income available for dividends; accumulated net profit or loss from sales of securities; surplus balance after giving effect to unrealized appreciation or depreciation, 1926–35*

	Year ended Dec. 31—										
	1926	1927	1928	1929	1930	1931	1932	1933	1934	1935	Balance, 1935
I. Net income available for dividends:											
Net ordinary income after operating expenses	$28,777.28	$215,309.28	$363,158.73	$539,174.09	$694,840.41	$825,832.81	$814,022.87	$831,750.97	$1,100,117.47	$2,053,694.68	$7,466,678.59
Portion of amounts received from sales of shares representing allowance for net income accrued at dates of sale, after adjustments for retirements	----------	10,613.42	11,621.31	24,249.76	43,848.68	27,687.15	8,236.69	27,102.48	55,517.48	261,858.59	470,735.56
Cash dividends paid	----------	204,269.85	342,089.63	505,769.37	717,809.41	942,619.91	795,737.26	859,449.45	1,143,270.65	2,334,148.23	7,845,163.76
Other charges	----------	9,492.91	8,383.14	15,699.12	16,911.91	22,067.67	18,994.49	----------	----------	----------	91,549.24
Balance of net ordinary income at end of period	28,777.28	40,937.22	65,244.49	107,199.85	111,167.62	----------	7,527.81	6,931.81	19,296.11	701.15	701.15

II. Accumulated net profit or loss from sales of securities:											
Net profit (loss) on sales of securities, less taxes thereon	4, 346. 83	21, 744. 49	204, 137. 67	355, 423. 15	(310, 599. 47)	(1, 971, 506. 17)	(6, 913, 474. 77)	(884, 072. 03)	(456, 704. 93)	691, 096. 31	(9, 259, 608. 92)
Special cash dividend declared payable from realized security profits			(95, 095. 00)								(95, 095. 00)
Amounts capitalized for shares issued as stock distributions less $57,239.76 transferred to reserve account				(24, 962. 00)	(37, 422. 35)	52, 179. 19					(10, 205. 16)
Miscellaneous (charges) credits net		1, 076. 85	(39. 25)	9. 46	(1, 079. 94)	(14, 021. 44)	1, 320. 45	(7, 580. 00)	(4, 286. 30)		(24, 600. 17)
Balance of accumulated net profit (loss) on sale of securities at end of period	4, 346. 83	27, 168. 17	136, 171. 59	466, 642. 20	117, 540. 44	(1, 815, 807. 98)	(8, 727, 962. 30)	(9, 619, 614. 33)	(10, 080, 605. 56)	(9, 389, 509. 25)	(9, 389, 509. 25)

TABLE 49.—*Massachusetts Investors Trust—Net income available for dividends; accumulated net profit or loss from sales of securities; surplus balance after giving effect to unrealized appreciation or depreciation, 1926–35*—Continued

	Year ended Dec. 31—										
	1926	1927	1928	1929	1930	1931	1932	1933	1934	1935	Balance, 1935
III. Summary of surplus after giving effect to unrealized appreciation or depreciation:											
Balance of net ordinary income available for dividends (see above)	$28, 777. 28	$40, 937. 22	$65, 244. 49	$107, 199. 85	$111, 167. 62		$7, 527. 81	$6, 931. 81	$19, 296. 11	$701. 15	
Balance of accumulated net profit or (loss) from sales of securities (see above)	4, 346. 83	27, 168. 17	136, 171. 59	466, 642. 20	117, 540. 44	$(1, 815, 807. 98)	(8, 727, 962. 30)	(9, 619, 614. 33)	(10, 080, 605. 56)	(9, 389, 509. 25)	
Balance of amounts reserved from gross income as sinking fund or accumulated surplus	1, 624. 41	11, 117. 32	19, 420. 46	35, 119. 58	49, 659. 29	12, 591. 52	29, 052. 74	28, 769. 54	28, 160. 34	14, 951. 34	
Total surplus	34, 748. 52	79, 222. 71	220, 836. 54	608, 961. 63	278, 367. 35	(1, 803, 216. 46)	(8, 691, 381. 75)	(9, 583, 912. 98)	(10, 033, 149. 11)	(9, 373, 856. 76)	
Unrealized appreciation (depreciation) at end of period		1, 481, 794. 00	3, 142, 733. 00	992, 896. 00	(4, 583, 813. 00)	(12, 251, 995. 00)	(6, 841, 373. 00)	(2, 156, 532. 00)	(87, 484. 00)	13, 591, 515. 00	
Surplus balance (deficit) after unrealized appreciation or depreciation		1, 561, 016. 71	3, 363, 569. 54	1, 601, 857. 63	(4, 305, 445. 65)	(14, 055, 211. 46)	(15, 532, 754. 75)	(11, 740, 444. 98)	(10, 120, 633. 11)	4, 217, 658. 24	

(d) Investment Trust Fund A and Investment Trust Fund B

Investment Trust Fund A was organized under the sponsorship of Roosevelt & Son, investment bankers of New York, and others, in the State of New York, under a special trust agreement dated January 1, 1925. The three parties to this indenture of trust were Investment Managers Company, managers, Central Hanover Bank and Trust Co., trustee, and the registered holders from time to time of so-called investment trust certificates, which were assignable and redeemable.

The prospectus stated:[115]

(3) That out of the net income derived from dividends, interest, etc., on the Investment Fund, the Registered Holder is entitled to receive distributions at the rate of 5% per annum on the face value of his Certificate, from the date of issue, payable quarterly on the second business day of January, April, July and October.

(4) That after the end of each calendar year the Registered Holder is entitled to receive as an additional distribution 12½% of his proportionate part of all income realized by the Investment Fund in excess of the 5% distribution on the face value of the Certificates.

Investment Trust Fund B, formed on April 15, 1927, by the same sponsors, also under a special trust agreement, was similar in most respects to Investment Trust Fund A. However, a fundamental difference existed between the two in that Investment Trust Fund B was accumulative, for it did not provide for any distributions of income.

The prospectus of Investment Trust Fund B stated:

(3) That all income derived from the Accumulative Fund is to be reinvested in the absolute discretion of Irving Investors Management Company, Inc., subject only to the provisions of the Investment Trust Indenture.

(4) That the proportionate part of such income applicable to each Certificate will be reported to Certificate Holders, in form to be used in preparation of their Federal Income Tax returns.

The certificates issued for capital and their redemption from time to time were recorded as follows on the books of these two investment trust funds.

The consideration received for the certificates was credited at face value to the Investment Trust Certificates Outstanding account. The balance in this account was at all times equal to the face value of the certificates issued and outstanding.

Upon redemption, the face value of the redeemed certificates was charged to the above account.

The difference between the face value of certificates redeemed, and the amount paid on redemption, constituting the profit or loss to the certificate holder, was charged or credited to the surplus account. This account included all items ordinarily carried in a surplus account, and included also adjustments arising from the redemption of certificates. The adjustments, comprising the profit or loss to certificate holders upon redemption, were allocated as:

(*a*) Amounts applicable to undistributed income, or accumulated deficit, from prior years;

(*b*) Amounts applicable to undistributed income or loss from current year;

(*c*) Amounts applicable to unrealized appreciation or depreciation in market value of securities in portfolio.

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[115] See also the summary of Article 4, Section 7 of this fund's trust indenture, infra.

To illustrate, the allocations in connection with redemption transactions of Investment Trust Fund A for the years 1928 and 1932 are summarized below:

	1928	1932
Face value of certificates redeemed	$6,293,900.00	$3,882,600.00
Amount paid on redemption	7,568,674.20	1,324,651.04
Profit (loss) to redeeming certificate holder	[a] 1,274,774.20	[b] (2,557,948.96)
Allocating profit (loss):		
Undistributed income (deficit) of prior year	554,247.21	(941,766.79)
Undistributed income (deficit) of current year	495,861.16	(413,677.44)
Unrealized appreciation (depreciation)	224,665.83	(1,202,504.73)
Total allocated	1,274,774.20	(2,557,948.96)

[a] Charged to surplus account.
[b] Credited to surplus account.

Prior to 1930, Investment Trust Fund A completely disclosed in its published reports the undistributed income and unrealized appreciation applicable to redeemed certificates. Thereafter, Investment Trust Fund A did not reveal this information in its published reports. Investment Trust Fund B completely disclosed these items to 1930, made partial disclosure for 1931, but made no disclosures after 1931.

With regard to its dividend policy, the management of Investment Trust Fund A stated: [116]

A rigid distributions policy is set up under Article 4, Section 7 of the Trust Indenture providing for the payment of regular quarterly distributions at the rate of 5% per annum of the face value of certificates outstanding at the end of each quarter year. This section gives the Board of Directors of the sponsor the power to continue to pay such distributions even though they may not be fully covered by dividends, interest or profits, or in such event to reduce the rate. The 5% rate was continued up to the end of 1932, and since that date the distributions have been paid at the annual rate of 2½% on face value. As these regular quarterly distributions at the rate of 5% per annum are cumulative it would be necessary for the unpaid accumulation to be made up before the extra distributions can be paid.

Analysis of the surplus account of Investment Trust Fund A (Table 50) reveals that after 1929 the distributions were not covered by dividend and interest income or realized profits; that since the end of 1929 the "principal" of the fund was impaired; and that despite the deficiency of earnings and the impairment of capital paid in, dividend payments were not suspended.

From the end of 1929 through 1935, the sum of $3,690,298 was distributed as dividends although capital was impaired as much as 70%,[117] after allowing for unrealized depreciation.

[116] Reply to the Commission's questionnaire for Investment Trust Fund A, Pt. V.

[117] Ibid. As was indicated in the case of Massachusetts Investors Trust, Investment Trust Fund A lacked the powers of a corporation which may use paid-in surplus and surplus arising from reduction of capital stock account to prevent or to remedy impairment of capital stock account.

As at Dec. 31—	"Principal" paid-in	Amount of impairment of principal	Percent of impairment
1930	$19, 907, 000	$5, 985, 280	30
1931	18, 863, 100	11, 303, 479	60
1932	14, 980, 500	10, 398, 733	70
1933	13, 467, 500	7, 641, 847	56
1934	11, 794, 100	7, 080, 260	60
1935	10, 365, 300	4, 839, 227	46

TABLE 50.—*Investment Trust Fund A—Analysis of surplus account, 1927–35*

Year ending December 31	Net ordinary income after operating expenses	Profits and (losses) upon sales of securities (less tax, 1935 only)	Net profit (loss) for year	Reserved for contingencies (and reversal) and expense thereon	Total credit (debit) adjustments account of redemptions
1926					
1927	$482, 914. 44	$928, 369. 78	$1, 411, 284. 22		($247, 586. 88)
1928	746, 879. 20	1, 322, 482. 52	2, 069, 361. 72		(1, 274, 774. 20)
1929	1, 011, 006. 77	2, 281, 108. 98	3, 292, 115. 75	$811, 591. 53	(757, 961. 20)
1930	649, 444. 65	(3, 163, 146. 82)	(2, 513, 702. 17)	(786, 231. 67)	63, 122. 43
1931	534, 430. 50	(3, 267, 896. 04)	(2, 733, 465. 54)		557, 703. 19
1932	270, 457. 94	(4, 366, 439. 84)	(4, 095, 981. 90)		2, 557, 948. 96
1933	116, 603. 87	(1, 059, 261. 44)	(942, 657. 57)		922, 522. 79
1934	94, 848. 13	(461, 321. 70)	(366, 473. 57)		956, 031. 95
1935	58, 496. 20	180, 161. 25	238, 657. 45		835, 516. 61
Balance, 1935	3, 965, 081. 70	(7, 605, 943. 31)	(3, 640, 861. 61)	25, 359. 86	3, 612, 523. 65

Year ending December 31	Dividend distributions	Surplus balance (deficit) at end of period	Unrealized appreciation or (depreciation) at end of period	Surplus balance (deficit) after giving effect to unrealized appreciation or (depreciation)
1926		$326, 049. 14		
1927	$674, 769. 80	814, 976. 68	$767, 891. 33	$1, 582, 868. 01
1928	786, 787. 19	822, 777. 01	1, 380, 229. 32	2, 203, 006. 33
1929	1, 084, 992. 98	1, 460, 347. 05	(1, 895, 660. 11)	(435, 313. 06)
1930	974, 879. 60	(1, 178, 880. 62)	(4, 806, 399. 64)	(5, 985, 280. 26)
1931	967, 871. 23	(4, 322, 514. 20)	(6, 980, 964. 81)	(11, 303, 479. 01)
1932	816, 501. 25	(6, 677, 048. 39)	(3, 721, 685. 34)	(10, 398, 733. 73)
1933	349, 445. 01	(7, 046, 628. 18)	(595, 219. 02)	(7, 641, 847. 10)
1934	308, 406. 25	(6, 765, 476. 05)	(314, 784. 48)	(7, 080, 260. 53)
1935	273, 195. 01	(5, 964, 497. 00)	1, 125, 169. 73	(4, 839, 227. 27)
Balance, 1935	6, 236, 848. 32	(5, 964, 497. 00)	1, 125, 169. 73	(4, 839, 227. 27)

(e) Incorporated Investors

As has been indicated, Incorporated Investors, organized under the laws of the Commonwealth of Massachusetts, allocated to undivided earnings account a portion of the proceeds received upon the sale of capital shares.[118] This portion was described as representing payments for participation in undivided earnings. Thus, when Incorporated Investors disbursed dividends from undivided

[118] See letter of accountants set forth, supra, p. 2015.

earnings, a part of this distribution was a return of paid-in capital. In addition, for the specific purpose of increasing the yield to the holders of the capital stock of Incorporated Investors, this company regularly distributed stock dividends, but, as will be shown, earnings were not the source of these distributions.

With reference to its dividend policy the company stated:[119]

It is the declarant's policy to distribute to shareholders in the form of cash dividends substantially all of the cash income of the declarant after deducting operating expenses. The sources of cash income are cash dividends received on investments, interest and that part of the proceeds received from the sale of new capital stock which represents payment for participation in earnings. Such cash income is credited to the undivided earnings accounts, and operating expenses and cash dividends paid by the declarant are charged to this account.

Since 1930 the company has paid a stock dividend semiannually of 2½% (prior to that time no set amount was paid). All stock dividends paid to shareholders are charged to Paid-in Surplus Account in the amount of $5.00 per share.

The cash dividends paid will be shown later. The so-called stock dividend record of the company is summarized below and includes a 100% stock dividend in 1928, and a 50% distribution in 1929, which in essence were stock split-ups.

Year	Stock dividends	Amount per share charged to paid-in surplus account for stock dividends paid	Year	Stock dividends	Amount per share charged to paid-in surplus account for stock dividends paid
	Percent			*Percent*	
1927	5	$1.00	1932	5	[c] $0.05–3.437
1928	104	[a] 1.00	1933	5	5.00
1929	56½	[b] 0.05–1.00	1934	5	5.00
1930	5	.05	1935	5	5.00
1931	5	.05			

[a] No transfer to capital account for 100% stock dividend; 4% stock dividends charged to surplus account at rate of $1 per share.

[b] Stock dividends of 4% charged at rate of $1 per share to surplus account. Stock dividends of 50% and 2½% charged at rate of $0.05 per share to surplus account.

[c] Stock dividend of 2½% charged at rate of $0.05 per share to surplus account. Stock dividend of 2½% charged at rate of $5 per share to surplus account. Includes a special charge to surplus of $3.437 a share, in order to bring stated value of capital stock account up to $5 per share.

While these stock distributions were charged to paid-in surplus account, they were charged at only a nominal value, as compared to prevailing prices.[120] These distributions were disbursed from paid-in capital, were intended to increase the "yield" upon the investment of the stockholder, and for a period of at least three successive years were made under conditions where substantial losses existed.

[119] Reply to the Commission's questionnaire for Incorporated Investors, Pt. V.

[120] The accounting principles pertaining to the treatment of stock distributions and the fact that these stock distributions were in the nature of stock split-ups, rather than stock dividends, are discussed in the section of this chapter dealing with stock distributions, infra, pp. 2038–47.

The emphasis placed upon the "yield" to the investor, the largest part of which yield came from the issue of stock dividends may be gathered from the following extract from the report to shareholders as at December 31, 1929:

PRICE RANGE AND YIELD

The following table shows the price and yield available on shares purchased in January of each year since 1926:

	Price	Dividends	Percent yield
January 1926	$100.00	$3.00	3.0
January 1927	109.00	9.00	8.2
January 1928	132.50	8.30	6.2
January 1929	[a] 93.50	8.65	9.2

[a] After 100 percent stock dividend, May 1928.

The above record includes both stock and cash dividends paid during each year [1926, cash $3.00; 1927, cash $3.50, stock, 5%, worth $5.50; 1928 cash $3.10, stock, exclusive of 100% stock dividend, 4%, worth $5.20; 1929 cash $1.35, stock 6½%, worth $7.30] and assumes the conversion of small stock dividends into cash on the day of payment, but excludes the stock dividend of 100% in 1928 and the 50% stock dividend paid in April 1929.[121]

A later publication, issued by The Parker Corporation, the distributors of Incorporated Investors, entitled "The Actual Record of Management of Incorporated Investors," stated with respect to its dividend record:

During the period of declining business activity from 1929 to 1932 Incorporated Investors paid substantially the same dividend to its shareholders. This was made possible by the fact that during this period the management shifted a substantial part of its funds into the stocks of so-called "defensive" companies—companies operating in relatively stable lines and able to earn and pay dividends in spite of the falling level of general business activity. As a result the shareholder of Incorporated Investors did not suffer a reduction in his cash dividend during the depression period.

Dividend paid per share

	Cash	Stock
		Percent
1929	[a] $1.19	[b] 6½
1930	1.00	5
1931	1.10	5
1932	1.00	5

[a] Adjusted for 50 percent dividend paid May 1, 1929.

[b] Exclusive of 50 percent stock dividend paid May 1, 1929.

[121] The portion shown within brackets, which is a break-down of cash dividends and stock distributions made in the period shown, was obtained from other published reports and from the reply to the Commission's questionnaire.

However, earnings were not the source of the stock distributions made by this company regularly each year in addition to cash distributions. This material information was not brought to the attention of the recipients of these dividends. William A. Parker, president of the company, when examined upon the regular disbursement of these stock dividends, testified:[122]

Q. One other point in regard to the selling of your securities. You, as I understand it, had rather low yield stocks in your portfolio rather than high yield stocks?

A. Yes, I think originally that can be said.

Q. That originally was so. Is it today?

A. Averaged up—I think that was probably so because we have included—

Q. So that your yield was not a great selling point?

A. No, nor has it ever been.

Q. You compensated for that by a 5 percent stock dividend, which, if I understand it rightly, was to put you into a position so that you would be on a comparable basis with high-yield stocks?

A. Well, perhaps that is a reasonable way to put it. It was our contention, very much along the lines of Mr. Leffler's testimony, that the ordinary individual, let us say, of moderate means, for whom these mutual companies are organized, found it very hard, at least in our opinion, to decide what securities he should buy. He was tempted to buy the XYZ preferred that yielded the 8 percent. In the course of running the Incorporated Investors we felt it necessary or deemed it wise to buy many low-yield securities. At the same time, we felt that this is the proper kind of security in the aggregate in its diversified form that the person of moderate means should buy. Feeling that he would not be willing to buy securities on so low a yield, we offered him in essence a return of capital which would make it possible for him to do it.

Q. That also helped your selling of the securities, didn't it?

A. Surely, I think.

Q. And that was a return of capital?

A. Yes; I think that is a fair statement.

Q. When you sent out those dividends of 5 percent, was it represented to the stockholders at the time you sent it out that it was a return of capital? In none of the material I see here do I understand it was.

A. I do not think that was as clearly labelled as I should label it today. I do not think there is any question about that. It was carefully explained to the dealers who, in turn, explained to the salesmen and the public what was the case. That was all put carefully before the dealers.

Q. You will agree that your prospectus, which we will take up in a little while, did not disclose that it was capital being paid?

A. I think in the light of my present knowledge of the ignorance of most investors that I would label it more clearly. Yes; I think so.

* * * * * * *

Q. Coming to the stock dividends, this statement further reads: "These items provide a convenient way by which the shareholder who needs to secure a larger income may do so by selling a stock dividend."

A. I think that is carelessly put.

Q. It is carelessly put, and he does not secure income by selling a stock dividend, does he?

A. He does under the new tax law, but, no, he doesn't in answer to your question.

* * * * * * *

[122] Public examination, Incorporated Investors, at 2562–4 and 2596.

Q. One final point. Taking your Incorporated Investors circular, which has no date, I want to call your attention to part of the statement in regard to dividends:

"The policy of Incorporated Investors has been to pay to the shareholders in the form of cash dividend substantially all of its net earnings. In accordance with established trustee practice only cash dividends and interest in cash and cash equivalent are regarded as earnings."

There again you do not include a statement as to the return to the shareholder of part of his original investment, do you?

A. No, we do not. We discussed that with Counsel. Counsel have okayed all these circulars.

The inclusion of the equalization proceeds in undistributed earnings account and the payments of cash dividends from this account are shown in Table 51. In the early period 1926 to and including 1929, these equalization proceeds, described as "Payments for Participations in Undivided Earnings," comprised a substantial part of the account. Since the largest part of the account was distributed as dividends in that period, a considerable portion of the cash dividends then paid constituted a return of capital. At no time, as already developed, were shareholders informed in dividend notices or in published reports of this characteristic of the dividend disbursements.

Moreover, in the years 1930–1932, the company failed to disclose in the published reports that equalization proceeds were included in earnings. In 1930, the equalization amount was included in the amount of "Net earnings from dividends and interest after expenses," while in 1932 and 1933 the equalization amounts were included in the amount of "Net Income after all expenses." Accordingly, an erroneous interpretation of the character of income account was inevitable. In the earlier years 1928 and 1929 this equalization item was shown separately under "credits" and described as "part of proceeds of sales of capital stock constituting payment for participation in undivided earnings." Beginning in 1933, after the failure to disclose from 1930 to 1932, the amount and description of this item was again furnished and shown under income or net income.

TABLE 51.—*Incorporated Investors—Analysis of undivided earnings account, 1926–35*

Period ended December 31—	Net ordinary income after expenses and taxes	Payments for participations in undivided earnings	Total of net ordinary income and payments for participations	Cash dividends paid during year	Balance of "undivided earnings" after dividends
1926	$19,041.34	$2,923.88	$21,965.22	$18,790.00	$3,175.22
1927	59,426.79	37,199.01	96,625.80	99,555.00	246.02
1928	316,667.24	106,902.47	423,569.71	325,961.70	97,854.03
1929	747,449.10	161,152.23	908,601.33	859,359.40	147,095.96
1930	985,321.50	7,956.23	993,277.73	900,157.40	240,216.29
1931	873,890.50	35,442.43	909,332.93	841,087.25	308,461.97
1932	691,964.09	115,435.77	807,399.86	995,740.00	120,121.83
1933	768,879.33	136,902.28	905,781.61	362,356.00	663,547.44
1934	1,178,328.06	48,983.42	1,227,311.48	1,040,525.50	850,333.42
1935	1,451,817.88	60,088.65	1,511,906.53	1,371,884.10	990,355.85
Total	7,092,785.83	712,986.37	7,805,772.20	6,815,416.35	990,355.85

In the years 1930, 1931, and 1932, cash and stock dividends were being continually disbursed, against a background of large amounts of investment losses. The surplus account, which was separate and apart from the company's undivided-earnings accounts, was built up principally from capital paid in upon the sale of capital shares and from reductions of capital-shares account. Out of this account, stock dividends were disbursed. Table 52 presents an analysis of the surplus account and summarizes the record of profits and losses upon the sale of securities, and the amounts reserved to reduce investments to the lower of cost or market. In the years 1930 and 1931, realized investment losses aggregated $9,969,437. In addition, at the end of 1931 the unrealized depreciation amounted to $18,215,492, which was reflected in reserve account, compared with $3,612,442 of unrealized depreciation at the end of 1929. Thus, in these two years security losses aggregated $24,572,487. In the following year, 1932, realized investment losses totaled $9,902,317. However, the unrealized depreciation declined by $7,033,396 to $11,182,096. Thus, the security loss in 1932 was $2,868,921. Therefore, for the three-year period, 1930 through 1932, investment losses aggregated $27,441,408. Nevertheless, during this three-year period stock dividends were disbursed from the paid-in surplus account (Table 52).

The company did not disclose these security losses in the annual reports to the shareholders. As stated, the losses were carried in this surplus account, but the company failed to include in any of the annual reports prior to 1934 an analysis of surplus account. An analysis of this account would have disclosed not only these losses to the stockholders but would have revealed that the stock dividends received were a return of capital.

TABLE 52.—*Incorporated Investors—Analysis of surplus account, 1926–35*

Period ended Dec. 31—	Proceeds allocated upon sales of capital stock	Reduction in capital stock (less increase to $5 par)	Total paid-in surplus	Credits (charges) arising from retirement and from resale of treasury shares and from treasury shares on hand	Profits and (losses) on sales of investments
1926	$347.50		$347.50		$4,113.22
1927	17,693.00		17,693.00		51,603.52
1928	49,075.50		49,075.50		49,363.74
1929	113,473.25		113,473.25	$1,206,497.43	32,390.38
1930	240,699.98	$20,287,720.48	20,528,420.46	1,125,713.46	(2,537,560.89)
1931	1,297,482.76	14,873,259.67	16,170,742.43	(565,451.63)	(7,431,876.09)
1932	1,923,660.89	(88,563.77)	1,835,097.12	(299,342.47)	(9,902,317.77)
1933	5,656,072.97		5,656,072.97	(52,019.02)	(1,998,798.43)
1934	3,763,252.69		3,763,252.69	(33,299.65)	(388,176.32)
1935	3,947,125.36		3,947,125.36	(25,393.05)	2,418,789.11
Balance, 1935	17,008,883.90	35,072,416.38	52,081,300.28	1,356,705.07	19,702,469.53

TABLE 52.—*Incorporated Investors—Analysis of surplus account, 1926–35*—Con.

Period ended Dec. 31—	Reserved to reduce investments to lower of cost or market, 1930–31, and release of excessive reserves 1932–34	Miscellaneous charges	Stock dividends paid	Balance at end of period	Unrealized appreciation (depreciation) not otherwise reflected herein at end of period
1926				$4,460.72	$32,781.50
1927		$2,638.30	$1,464.00	69,654.94	584,285.86
1928		80.00	9,652.00	158,362.18	6,669,411.68
1929			35,078.30	1,475,644.94	(3,612,442.21)
1930	($13,200,749.93)		2,205.95	7,389,262.09	106,134.75
1931	(5,014,742.04)		2,134.90	10,545,799.86	
1932	6,755,406.07		129,956.50	8,804,686.31	277,990.00
1933	5,534,064.07	65,932.64	344,410.00	17,533,663.26	4,840,922.37
1934	5,926,021.83	40,689.91	500,460.00	26,260,311.90	(773,354.87)
1935		370,793.25	596,105.00	31,633,935.07	9,028,185.22
Balance, 1935		480,134.10	1,621,466.65	31,633,935.07	9,028,185.22

13. DIVIDENDS PAID IN KIND

Several of the closed-end investment companies paid "dividends in kind." Portfolio securities were distributed to stockholders as dividends out of surplus, as distinguished from liquidating dividends. In accounting for the disbursement of such dividends in kind, some of the companies diminished both portfolio and surplus account at the book value of the stock. The effect of this treatment was to fail to record on the books the amounts of appreciation or depreciation between book value and market value of the stock at time of disposition to the stockholders.

For example, Blue Ridge Corporation, during 1935, distributed as a dividend on its own common stock 746,337 shares of Central States Electric Corporation, which had a book value of $1,797,953 and a market value on date of declaration of $1,026,213. Surplus account was charged with the book value. As a result, the loss of $771,740 represented by the difference between book and market values was not made a matter of record. However, it must be noted that the net result in surplus account would be the same under either base of valuation of the stock distributed. If the stock had been charged out at its market value of $1,026,213, a loss of $771,740 would have been charged to surplus. After this adjustment of book to market value, portfolio and surplus account would be charged for the dividend at the market value of $1,026,213. Thus, there would be two charges in surplus account aggregating $1,797,953, equal to the single charge of $1,797,953 upon the book-value basis.

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14. STOCK DIVIDENDS [123]

Several of the investment companies reviewed disbursed stock dividends and distributed shares in the course of stock split-ups. A clear distinction between stock dividends and stock split-ups was not made in notices or in reports to stockholders. A stock split-up is no more than a division of the outstanding capital stock into a larger number of shares. These split-ups are usually made for no other purpose than to further diffuse the ownership of the stock among the public because of the proportionate lowering of the prevailing price of the stock. A stock split-up has no relation to earnings. A stock dividend may, like a stock split-up, effect a wider public distribution of the company's stock. The essential feature of a true stock dividend from an accounting view point is that it is a capitalization of earnings.

The discussion of accounting practices with respect to stock dividends issued by investment companies covers two factors: (a) the extent to which stock split-ups were confused with stock dividends, and (b) the adequacy of the amounts by which surplus account was reduced upon the distribution of stock dividends.

A harmful practice was found to exist with respect to the recording of stock dividends.[124]

One accounting view holds that upon the issue of a stock dividend the amount which should be transferred to capital-stock account from distributable earnings account is, as a minimum, the sum per

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[123] For a further discussion of stock dividends and stock split-ups, see pp. 2381–95.

[124] Paton, W. A., ed., *Accountants' Handbook*, 2nd ed. (1932), p. 939, enumerates a variety of methods used to record stock dividends:

"*Methods of Recording Stock Dividends.* Hoxsey has indicated nine methods of recording stock dividends which have been reported to the New York Stock Exchange:

"1. No entry affecting capital stock and surplus where no-par stock has no stated value.

"2. The transfer of a nominal sum from capital (paid-in) surplus to capital stock.

"3. The transfer of an amount equal to the stated or par value of the dividend stock from capital (paid-in) surplus to capital stock.

"4. Same as 2 except that the transfer is made from earned surplus.

"5. Same as 3 except that the transfer is made from earned surplus.

"6. The transfer, for each share of dividend stock, of an amount of earned surplus to capital stock, and, if any, capital (paid-in) surplus equal to the already existing value per share in the two latter accounts.

"7. Same as 6, except that the amount transferred is less than the market value per share and more than the amount transferred under 6.

"8. The transfer to capital stock and paid-in surplus of an amount equal to the previously existing book value per share, including in the book value earned surplus.

"9. The transfer to capital stock and paid-in surplus of the market value of the dividend stock."

The *Accountants' Handbook* continues the review of methods used to record stock dividends as follows:

"Another method of recording no-par dividend stock is sometimes advocated: the transfer to capital stock of a portion of earned surplus equal to the amount thereof applicable to each share of stock before the dividend stock is issued, multiplied by the number of dividend shares. Under this method a dividend of 50 percent would absorb half of earned surplus; a dividend of 100 percent, all of the earned surplus. This method may be dismissed as being without merit; a stock dividend must be valued in terms of existing share values. Otherwise stock dividends should be regarded as split-ups and no surplus transferred to capital stock.

"Most accountants subscribe to Method 5: Hoxsey favors 1 for stocks having no declared or par value, and 6 for all others; Wildman and Powell, 1 and 5; Montgomery prefers method 9 for all no-par stocks issued as a dividend, whether or not having a stated value, with method 5 as a minimum measure of the transfer."

share in capital and capital-surplus accounts. In most cases the sum per share in capital and capital-surplus accounts would be equivalent to the paid-in value of each share. This method discourages the use of earned-surplus account as a source of further distributions without additional earnings. This accounting method was urged in an announcement in 1930 by the New York Stock Exchange, on stock dividends.[125]

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[125] This announcement is as follows:

NEW YORK STOCK EXCHANGE—FURTHER ANNOUNCEMENT ON STOCK DIVIDENDS

The following statement supplements and extends but does not alter the report of the Special Committee on Stock Dividends adopted by the Governing Committee on September 11, 1929.

In the study of the questions leading up to that report, and in considering the problems arising out of giving effect to it, the Committee on Stock List has reached the following definite conclusions, which it seems well to make public for the information of corporations desiring listing:

As recognition of the importance of earnings in the evaluation of securities tends to be emphasized the importance of an accurate segregated statement of Earned Surplus in the Balance Sheet does so likewise. Accounting should be adapted to the end that this account should show at any given time the exact amount of realized undistributed earnings, either from date of organization, or, in the event of recapitalization, from some fixed stated date. The fact that state laws may permit stock dividends to be paid without any charge against earnings or earned surplus or with only a nominal charge has no bearing upon the correct accounting procedure to be followed.

An occasional large split-up, made for convenience in the form of a stock dividend and capitalized at a nominal amount, whether charged against Earned Surplus or Capital Surplus, is not objectionable, if accompanied by a statement that it is in effect a split-up.

The issuance of periodical Stock Dividends with either no charge or with an insufficient charge against Earnings or Earned Surplus, while not illegal under the laws of some States, is apt to mislead stockholders and is not regarded as good practice. If such dividends are declared, they should be accompanied by a statement clearly indicating either that they are not true earned stock dividends or, if actually earned but insufficiently charged against Earnings or Earned Surplus, that the method of accounting leaves in Earned Surplus an amount which may be again used for dividends without further earnings.

In the accounting for Stock Dividends upon the books of the issuing Company, whether for stock with par value or without par value, Capital and Capital Surplus should be regarded together as the consideration, other than earnings, represented by the stock. The sum per share of these two accounts is the minimum amount per share to be issued as a Stock Dividend, which should be charged against Earnings or Earned Surplus in order that such dividend may be termed a true earned Stock Dividend properly accounted for and in order that Earned Surplus may not include a fictitious amount available for further dividends without further earnings.

In cases where there exist substantial uncapitalized assets, tangible or intangible, the amount of the charge against Earnings or Earned Surplus should be larger than this minimum amount.

In cases where stock is issued either as interest upon funded debt or as a dividend upon stock of another class with a cash alternative, the amount of such cash alternative measures the minimum amount properly to be charged against Earnings or Earned Surplus. The effect of issuing stock as interest or dividends upon other securities should be merely to conserve cash and not to add to the apparent Earnings or the apparent Earned Surplus, as contrasted with the effect of the cash alternative.

The Exchange will not decline to list, for the present at least, ordinary periodical Stock Dividends insufficiently charged against Earnings or Earned Surplus, providing proper disclosure is made of the nature of such dividends. Stock issued as interest or as dividends upon other securities with a cash alternative will not be regarded as available for listing if it is to be charged against Earnings or Earned Surplus at less than the amount of cash surrendered, excepting as to further issuance of stock under such conditions in cases where such application or applications for listing the senior securities bearing such alternative Stock Dividends, may have been approved before the objections to the practice were clearly apparent, or unless accounting procedure should develop in a direction which cannot now be

A broader view of this method is to apply to the shares issued as stock dividends upon the same class of stock the actual paid-in value per share of the outstanding shares. Under this procedure, the issue of the stock-dividend shares does not reduce the paid-in value of the outstanding shares. There is, of course, no change in the total equity value of the shares of stock in the hands of the stockholder immediately upon receipt of the stock-dividend shares, no matter what basis of value is adopted for recording in capital-stock account the shares issued as dividends. However, a probable advantage of applying paid-in value to the shares issued as dividends, is to deter the management from the continued use of surplus-earnings account as the ostensible source of dividends without commensurate diminution.

a. Closed-End Companies

Table 53 indicates the accounting treatment accorded capital shares distributed (designated as stock dividends) by seven closed-end companies selected as examples.

In only one instance was earned-surplus account charged at the average paid-in value for capital shares distributed as a dividend. All other companies studied capitalized stock dividends at par value, or at the stated values per share, which in some instances were substantially below the indicated paid-in values.

(1) CENTRAL STATES ELECTRIC CORPORATION

Central States Electric Corporation made a 100% stock distribution in April 1929 and a 200% stock distribution in July 1929 in the form of stock dividends. Only $1 per share was charged to earned-surplus account. While the paid-in value of outstanding capital shares was not readily ascertainable, the nominal character of the $1 charge in April 1929 is seen when compared to the market value of $80 per share. The total market value of $98,006,080 of the 1,225,076 shares distributed as a dividend should be compared with the comparatively small amount of $1,225,076 charged to earned-surplus account. Likewise, in July 1929, only $1 per share was charged to surplus account for the 5,138,102 common shares distributed or a total of $5,138,102, which should be contrasted with the $256,905,100 market value of this

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foreseen, in such manner as to warrant considering full disclosure as adequate protection to security holders of all classes.

The Exchange will not knowingly list any of the securities of a corporation which takes up as income upon its books Stock Dividends received at a larger figure than the proportionate amount charged against Earnings or Earned Surplus by the issuing Company. Where the issuing company declines to give this information, objection will be made if the receiving company regards such stock dividends as income to any extent whatever.

Attention is called to the fact that in the rapidly changing conditions of modern business, the Exchange is frequently called upon to consider from a listing standpoint an accomplished fact in corporate finance, upon which immediate action is imperative, without adequate time for the consideration of the new problems involved. Such action will not be regarded as creating a precedent upon which reliance may be placed, if further consideration indicates that the action taken is not in the best interest of the public and of the Exchange.

Recommended to the Governing Committee by the Committee on Stock List, at its meeting held April 28, 1930.

Also in its "Special Requirements for Listing Investment Trust Securities," as amended to April 1931, the New York Stock Exchange required that the applicants agree that stock dividends will be charged against earnings on what appears to the Committee on Stock List to be a reasonable basis.

stock, $50 per share. The accounting treatment was more nearly that of a stock split-up than that of a stock dividend, which was the description utilized by the management.

(2) GENERAL AMERICAN INVESTORS COMPANY, INC.

Similarly, General American Investors Company, Inc., in its published reports, described a distribution as a "stock dividend" where the accounting treatment accorded that distribution was more nearly that of a stock split-up. A 100% stock distribution in May 1929 in the form of a stock dividend increased outstanding common stock from 200,000 to 400,000 shares. No charge was made to earned-surplus account. There was a transfer of five cents per share to capital-stock account from capital-surplus account, which was comprised of a portion of the proceeds obtained from the original issue of capital stock. In July 1929, only a short time after the 100% stock distribution the company disposed of an issue of 400,000 shares of common stock at $15 per share through rights issued to stockholders. Of the $15 received per share, $4.95 was added to the stated value of five cents per share of the 400,000 shares previously outstanding, $5 was allocated to capital-stock account for the 400,000 shares currently sold, and $5.05 was allocated to capital-surplus account. The five cents charge to earned surplus for the 200,000 shares distributed in May 1929, total $10,000, was not changed, leaving earned surplus practically undiminished for future dividends. In character, this was a split-up, but was described to stockholders in the 1929 published report as a stock dividend. (See table on pp. 2042–2043.)

(3) UNITED FOUNDERS CORPORATION AND AMERICAN FOUNDERS CORPORATION [126]

United Founders Corporation and American Founders Corporation, affiliated companies, in published reports and in notices to investors and to the public unequivocally stated that capital stock distributed as dividends constituted a disbursement of dividends in shares in lieu of cash.

In United Founders Corporation dividends were all in the form of stock, none in cash. In the aggregate, United Founders Corporation distributed 544,467 shares of its no par value common stock as dividends, beginning January 2, 1930, and continuing at the end of each quarter to January 2, 1931. Despite continual offerings of issues of its common stock throughout this period for cash and in exchanges at various values, a fixed charge of $10 per share was placed during this entire period on each share distributed as dividends, and earned surplus was charged at this fixed rate for a total of $5,444,675. The $10 charge did not represent either stated value or paid-in value. Upon a paid-in-value basis the charge to earned surplus would have aggregated $18,553,623. The difference between the $10 basis and the paid-in-value basis was $13,108,948. This indicates the large amount of free play in earned surplus account which can arise from the use of an arbitrary value as against a base of paid-in value.

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[126] For more detailed discussion of these companies, see Secs. 11 and 111 of this chapter, infra.

TABLE 53.—*Treatment of capital shares distributed as dividends by 7 closed-end investment companies, 1929–32*

Company	Stock dividends distributed: Year	Number of shares	Class of stock distributed	Capitalized: Total amount	Basis	Per share	Surplus account charged	Approximate average paid-in value per share previously issued (other than stock dividend shares)	Market prices where paid-in value was not readily ascertainable from reply to questionnaire
American Cities Power & Light Corporation.	1929	193,674	Class B stock	$1,936,740.00	Stated value	$10.00	Earned surplus.	$12.50	
	1930	265,312	do	2,653,120.00	do	10.00	do	12.50	
	1931	206,203	do	1,031,017.00	do	5.00	do	12.50	
	1931	200	do	200.00	do	1.00	do	12.50	
	1932	207	do	207.00	Par value	1.00	do	12.50	
		665,596		5,621,282.00					
American Superpower Corporation	1927	20,958	Common stock	104,790.00	Stated value	5.00	do	([b])	1927 market—high $41, low $27; 1928 market—high $67, low $33; February 1928, subscription price with rights, $33; December 1928, subscription price with rights, $42.50.
	1928	54,250	do	54,250.00	do	1.00	do		
		75,208		159,040.00					
Blue Ridge Corporation	1929	5,393	do	50,478.77	Not indicated	9.36	do	10.97	
	1930	5,054	do	48,717.84	do	9.64	do	10.97	
	1931	550	do	5,340.67	do	9.71	do	10.97	
	1933	181	do	2,030.86	do	11.22	do	10.97	
		11,178		106,568.14					
Central States Electric Corporation	1928	85,044	do	85,044.00	Stated value	1.00	do	([b])	July 1, 1928–Oct. 1, 1928, market—high $120, low $30; Jan. 1, 1929 market $115; Apr. 1, 1929, after 100 percent dividend, market $80; July 1, 1929, after 200 percent dividend, market $50; Jan. 1, 1930 market, $20; Apr. 1, 1930–Oct. 1, 1930—market,
	1929	520,067	do	520,067.00	do	1.00	do		
	1929	1,225,076	do	1,225,076.00	do	1.00	do		
	1929	5,138,102	do	5,138,102.00	do	1.00	do		
	1930	912,360	do	912,360.00	do	1.00	do		
	1931	481,695	do	481,695.00	do	1.00	do		
		8,362,344		8,362,344.00					

Electric Shareholdings Corporation	1929	84,206	do	842,060.00	do	10.00	do	22.00	high $39, low $18; Jan. 1, 1931 market $9; Apr. 1, 1931–Oct. 1, 1931, market—high $11, low $2.
	1930	50,299	do	502,990.00	do	10.00	do	22.00	
	1931	70,865	do	354,325.00	do	5.00	do	22.00	
	1931	187	do	187.00	Par value	1.00	do	22.00	
	1932	257	do	257.00	do	1.00	Capital surplus.	22.00	
		205,814		1,699,819.00					
General American Investors Co., Inc.	1929	200,000	do	10,000.00	do	.05	do	1.52	
Mayflower Associates, Inc.	1930	11,803	do	678,672.50	Average paid-in value.	[a] 57.50	Earned surplus.	57.50	

[a] Of the sum of $57.50 capitalized, the amount of $50 was allocated to Capital Stock Account, and $7.50 to Capital Surplus Account.
[b] Not readily ascertainable from reply to questionnaire.

American Founders Corporation also followed the procedure of charging earned surplus account at an arbitrarily fixed amount less than paid-in value for dividends disbursed in stock in lieu of cash. In November 1928, the corporation paid a stock dividend of 11,021 shares for which surplus account was charged $10.50 per share. However, in the entire period from February 1, 1929, to November 1, 1930, surplus account was charged for each common share issued as a dividend at the fixed price of $9 per share, and the equivalent rate of $3 per share when each common share was split three for one in November 1929. The total charge to surplus account was $3,747,551. The exact paid-in value of shares outstanding was not readily ascertainable, but in approximate figures the paid-in value, when applied to all the shares distributed as dividends, amounted to $14,600,000. The margin between the $3,747,551, as charged to surplus account, and the said approximate amount of $14,600,000 is more than $10,000,000. The use of the arbitrary base of $9 per share preserved earned surplus account. If the paid-in valuation were the basis, the earned surplus account of $8,186,809 existing at November 30, 1930, when the regular practice of issuing dividends ceased, would have been wiped out by additional charges as estimated above of about $10,000,000.

(4) ELECTRIC SHAREHOLDINGS CORPORATION

In Electric Shareholdings Corporation, earned surplus account was charged the aggregate sum of $1,699,819 for stock dividends. When compared to a charge on a paid-in-value basis at $22 per share, or $4,528,908, the $1,699,562 charged to earned-surplus account was deficient in the amount of $2,828,089, representing, on the paid-in-value basis, that much of earned surplus account which remained available for additional dividend distributions without additional earnings.

b. Open-End Companies

Of the 14 open-end companies reviewed, five made stock distributions to shareholders. In two of these companies, the stock distributions were capitalized out of earnings at such inadequate sums that from an accounting viewpoint they should have been designated as stock split-ups, rather than as stock dividends. In the three other companies, there was no capitalization of earnings. The distributions were charged out of paid-in surplus accounts, and all at nominal values. The absence of capitalization of earnings, and the inadequacy of the charges, characterize these distributions also as stock split-ups. In two of these cases there was a periodical distribution of shares. It should be observed that these regular stock distributions charged to paid-in surplus accounts at small sums may have caused the recipients to believe that the liquidation of these particular shares added to the yield upon the investments. It will be remembered that in Incorporated Investors, representations were made to the shareholders that the yield upon their investment consisted of the amount of the cash dividends received and the liquidating values of the shares received.

(1) STATE STREET INVESTMENT CORPORATION

State Street Investment Corporation, an open-end company, declared a "100% stock dividend" payable January 15, 1929, to stockholders of record December 31, 1928. At this date, 63,086 shares of common stock were outstanding. Accordingly, 63,086 shares were distributed, for which the company charged earned surplus account $1 per share. Immediately prior to this distribution the paid-in value of each outstanding share was $104.90. If earnings were to be capitalized in accordance with accounting principles hereinbefore set forth, earned surplus would have been diminished at the rate of $104.90 per share, or $6,617,721. At the end of 1928, the balance in the earned surplus account, which included profits from the sales of securities, was $1,619,113. This sum, of course, was insufficient to bear a charge on any conservative basis for a distribution which doubled the number of outstanding shares, each of which had a net asset value close to $200. The $1 charge to earned surplus account, and the $1 credit to capital stock account, did no more than distinguish these shares on the records from other shares. The result was not a capitalization of earnings, but a change in the form of ownership. Each outstanding share was split into two shares, as a result of which the price prevailing of $200 a share for newly issued stock before the 100% stock distribution was brought down to an easier level for disposition to the public at approximately $100 per share. This stock distribution was in actuality a two-for-one split-up.

(2) NATION-WIDE SECURITIES COMPANY

On October 2, 1933, Nation-Wide Securities Company, an open-end organization, made a distribution of shares to its stockholders of record September 20, 1933, which the company described as a 600% stock dividend. There were 36,241 shares outstanding, and the distribution consisted of 217,446 shares. Just prior to this distribution, on September 14, 1933, the par value of the company's capital stock was reduced from $1 to 25 cents per share. Upon the distribution of the 217,446 shares, a charge was made to capital surplus account at par value of 25 cents per share, a total of $54,361.50. This capital surplus account was built up only of amounts received in excess of the par value of capital shares sold. No portion of earnings account was disturbed, and the balance therein remained as a source for cash dividends distributed regularly each quarter. This account was almost completely exhausted by the expenditure of cash dividends within a short period after the 600% stock distribution.

The reduction of the par value of the stock from $1 to 25 cents, and the multiplication of outstanding stock as much as seven times by a distribution to stockholders without any diminution of earnings account, which was left free to be utilized in full for cash dividends, were indicative of a seven-for-one stock split-up, and not a stock dividend, as published by the management.

(3) THE MARYLAND FUND, INC.

In its published report for the fiscal year ended November 30, 1935, The Maryland Fund, Inc., stated:

During the past 12 months three stock distributions of 3% each have been paid. The regular stock distribution rate contemplated, however, is 3% twice yearly, payable June 15 and December 15. The extra stock distribution paid during the past year on February 1, would ordinarily have been paid December 15 of the preceding year.

So that stockholders may understand fully the distribution policy of the Fund, it may be summarized as follows: The policy is to pay a regular quarterly distribution of 10 cents per share in cash, supplemented by two or more extra distributions of 5 cents annually, and two distributions of 3% in stock.

The interim report of May 31, 1935, stated:

The present policy of the Fund, which results in semi-annual distributions of 3% in stock, enables stockholders to increase the number of shares held without paying the usual commission for selling expense and profit. * * * However, as explained in a previous communication, stockholders desiring to realize the cash value of their stock distributions, may obtain liquidating value by forwarding the shares to the Fund or may sell them in the open market through any investment banker.

For the three stock distributions of 3% each mentioned above which aggregated 9,405 shares, The Maryland Fund, Inc., charged paid-in surplus account with the sum of $940.50, or at the rate of 10 cents per share, which was the par value of the stock.

This paid-in surplus account was comprised of practically the entire proceeds obtained from the sales of capital shares. Only the par value of 10 cents per share was entered in capital stock account—a charge which was an insignificant part of the price received per share. The price per share of an open-end company is based upon the current liquidating value, plus a service charge. At the beginning of the fiscal year 1935, this liquidating value was $15.33 per share, while at the end of 1935 it was $17.33 per share. When, as here, less than 1% of proceeds received from sales of capital shares are entered in capital stock account, an unusual situation arises. At November 30, 1935, the balance of capital stock account was only $28,020.60, as compared to the balance of $4,356,178.14 in paid-in surplus account.

In addition, the company, in connection with a stock distribution, in the 1935 fiscal period, paid cash in lieu of fractional shares aggregating 800 34/100 shares at liquidating value at record dates of distributions. This disbursement amounted to $13,520, and was charged to paid-in surplus account. This $13,520 charge, at liquidating value for 800 34/100 shares, may be compared with the nominal par value charge, aggregating $940.50, for 9,405 shares made in the same account with respect to the same stock distribution.

Earnings, including net profits on investments sold, were carried in earned surplus account, which from date of incorporation, June 22, 1934, to November 30, 1935, amounted, net, to $55,340.93. The company distributed $41,577.03 of this sum in 1934 and 1935 as dividends in cash. Thus, at November 30, 1935, there remained in earned surplus a balance of $13,763.90.

As the stock distributions were not a capitalization of earnings, and since the shares issued were recorded on the books at amounts which bore no relation to their true value, these distributions could not be regarded as stock dividends in an accounting sense. The company described its distributions to stockholders as cash distributions and as stock distributions. Had they been described as cash dividends and as stock distributions, respectively, the distinction that one was a dividend and that the other was in nature a stock split-up might have been evident to stockholders. Payments in cash and in stock were both characterized as distributions. Misunderstanding by the stockholders of the character of the stock distributions might have been removed if these distributions were described as stock split-ups. The stock distributions accomplished no more than "to increase the number of shares held," as was stated in the stockholders' report.

(4) MASSACHUSETTS INVESTORS TRUST

Massachusetts Investors Trust, an open-end "Massachusetts trust," stated its dividend policy to be: [127]

> * * * In the annual report for 1928 the Trustees announced that instead of paying any extra dividend from capital gains they would pay stock dividends semi-annually at 1%. Such stock dividends were paid semi-annually until March 1932. Share distributions were discontinued thereafter as they did not affect the value of the shareholders' interest in the Trust, and the expense connected therewith was constantly increasing.

This company maintained an account entitled "Accumulated Net Profit or Loss from Sales of Securities." The 1% stock dividends referred to above, except the one in 1932, were charged to this account. While these charges and the resulting credits to capital stock account comprised a capitalization of investment profits, this capitalization was at a nominal rate per share as compared to the paid-in value. In 1929 and 1930, the shares distributed were capitalized at $5 per share. The prices paid in for stock in 1929 ranged from a low of 40¼ to a high of 64⅞. In 1930 the low was 31½ and the high was 53⅜. In 1931 dividend shares were capitalized at slightly less than 50 cents each. In that year, prices paid in ranged from a low of 16⅜ to a high of 37½.

For the 1% stock distribution of March 1932, a memorandum entry was made in capital stock account of the number of shares issued but without money amount. No charge was made in any surplus account for this distribution. As there was no capitalization of earnings, and as the matter was treated as only an increase in the number of shares outstanding, this 1932 stock distribution came within the classification of stock split-ups. The inadequacy of the charges to earnings account for the stock distributions in the prior years placed them in the category of stock split-ups rather than in that of stock dividends which they were presumably intended to be.

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[127] Reply to the Commission's questionnaire for Massachusetts Investors Trust, Pt. V.

15. ACCOUNTING TREATMENT OF STOCK DIVIDENDS RECEIVED

Approximately three-quarters of the closed-end and open-end companies reviewed entered stock dividends received at no valuation, while the others, in including dividend shares in income and surplus account, used four different methods of valuation.[128]

The large number of companies which placed no value upon dividend shares received apparently relied upon the decision of the United States Supreme Court that stock dividends are not income to the recipient within the meaning of the Sixteenth Amendment to the Constitution.[129] When the dividend shares, to which no value had been allocated, were added to the number on hand, the effect was to reduce the average cost of each share in the entire lot. Thus, if a 10% stock dividend was received upon a lot of 100 shares previously acquired at an average cost of $11 per share, total $1,100, the cost of $1,100 was applied to the increased lot of 110 shares, and the average cost was reduced from $11 to $10 per share. If and when any of these dividend shares were sold, only that portion of the proceeds was considered earnings which exceeded the new average cost per share, or as in the example cited above, $10 per share.

This treatment of averaging down the cost of the shares of a particular investment by adding dividend shares to it at no value, would not be used where the dividend shares received were not identical in every

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[128] The New York Stock Exchange Report of the Special Committee on Stock Dividends, dated September 4, 1929, with regard to the accounting treatment of stock dividends received, stated in part:

"When stock dividends are received by investment trusts, holding companies, or other corporations, the manner in which these dividends are accounted for by the receiving company presents a problem somewhat different from that attending the accounting for the payment of stock dividends by the declaring company. Current practice varies all the way from the policy of ignoring stock dividends in their entirety in the income account of receiving companies, to the policy of taking them into the income account whether they have been realized upon or not at the full market value on the date received.

"Uniform accounting practice today seems to favor as sound procedure the ignoring of stock dividends in the income account of receiving companies. However, it has been urged on behalf of investment trusts, holding companies, and others, with what seems to us to be some measure of justification, that a technical interpretation of the nature of stock dividends may operate to hamper management in the adopting of perfectly reasonable and proper dividend programs of their own, whether in cash or in stock, and may even under certain circumstances force them as recipients, for technical reasons, to realize upon stock dividends which for business reasons they would have preferred to hold.

"It may be that accounting practice will undergo certain modifications in the light of these new tendencies, but it is too early to form an opinion as to the direction that this modification is apt to take. It is possible that a schedule of all stock dividends received will suggest itself as a desirable addition to the annual report of investment trusts, holding companies, and others; or, conceivably, a new departure in accounting theory may permit the inclusion of stock dividends in some form or other in the income accounts of receiving companies.

"At the present time, it appears as if the Exchange could go no further than to take the position that it will raise no objection to the method by which investment trusts, holding companies, and others account for stock dividends received by them and not realized upon, provided there is the fullest disclosure of the procedure adopted, and provided that these are not included in the income accounts of the receiving companies at a greater dollar value per share than that at which they have been charged to income account or earned surplus account by the paying companies. The manner in which receiving companies account for stock dividends received by them and realized upon during the period under review is a matter which the committee will pass on in connection with each specific instance."

[129] *Eisner* v. *Macomber,* 252 U. S. 189.

material respect of ownership interest with that of the stock upon which the dividend was paid—for example, preferred shares received as a dividend upon common stock held.[130]

a. Closed-End Companies

Of the 62 closed-end companies reviewed, two received no stock dividends, while five furnished no specific information with regard to stock dividends received. Of the remaining 55, 43 took all dividend shares received into account at no valuation. One other company handled such shares in the same manner, except during one year. Two other companies took dividend stock into account at no valuation, after first including them in income account, one company at entire proceeds received from the sale of the stock, and the other upon a basis not revealed. One closed-end company followed the practice, with respect to stock received from companies whose policy it was to issue shares as stock dividends at regular intervals, of selling these shares upon receipt and entering the proceeds in the account for profits and losses from the sales of securities. The remaining eight closed-end companies assigned a value to dividend shares received. One of these companies did so after first following the practice of entering dividend shares at no valuation. Another company placed a value only upon dividend shares which were issued regularly from time to time, but not upon other stock dividends received. When a valuation was fixed upon dividend stock received by these eight companies, it was added to the amount in investment account and in equal amount to the income account. One company, Electric Power Associates, however, changed the practice and entered the sum in capital surplus account rather than in income account. This particular company had made changes previously with respect to its treatment of stock dividends received. At first its practice in 1929 was to enter dividend shares at no value. During 1930, 1931, and 1932, the procedure was to value the shares at closing market value at the date of receipt, and credit income account for the amount. During 1933, 1934 and 1935, the company entered the market value of the dividend shares in capital surplus account.

Market value at time of receipt, as mentioned above, was only one of three bases for valuing dividend shares received by these eight closed-end companies.[131] A second method was to take the shares into

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[130] The treatment involved in such instances is not reviewed, since such cases were rare among investment companies during the period under review.

[131] The weaknesses which are present in the policy of treating stock dividends received as items of income at market value, are expressed by George O. May of Price, Waterhouse & Co. in *Twenty-Five Years of Accounting Responsibility*, (1936), pp. 387 and 391, as follows:

"The periodical stock dividend policy is, as I understand it, predicated on the belief that in such businesses there is a continuous opportunity to invest new money at more than the going rate of return on comparable investments, and that the method of withholding cash dividends and declaring stock dividends conserves this benefit to the stockholders to the full extent of the annual earnings in the most advantageous way. Those who advocate this practice usually insist that it is legitimate only if it is reasonably expected that the earnings a share will not be reduced by the procedure adopted.

"Even upon these assumptions I am convinced that it is wholly incorrect to treat such dividends received as income to the extent of the market value of the stock received at the time of its receipt. I say that it is wholly incorrect because I am convinced that it is

account at the pro rata amount charged to surplus by the issuing company, while a third basis was to account for the dividend stock at cash option value. When the issuing company gave the stockholder the option of collecting the dividend in shares or in cash, and the stockholder elected to take shares which were entered at the cash option value, the stockholder did so upon the theory that the transaction was no different from that of a cash dividend which had been declared with the privilege of subscription to an equivalent amount of new shares.

(1) CENTRAL STATES ELECTRIC CORPORATION AND AMERICAN CITIES POWER & LIGHT CORPORATION

Central States Electric Corporation and its subsidiary, American Cities Power & Light Corporation, were among the eight closed-end companies which assigned a value to dividend shares received. The practice of these two companies was alike. These companies described their treatment of stock-dividends receipts as follows: [132]

> The investments of the declarant have been to a large extent in certain companies which pursued, prior to December 31, 1934, the policy of paying dividends in stock, thereby financing in part the growth of their business through the reinvestment of their earnings. Stock dividends, therefore, have constituted an important part of the income of the declarant and have been consistently valued, since the inception of the corporation, at average market prices for the three full business days following the respective dividend record dates. In view of conditions and shrinkage in portfolio values, however, part or all of the valuation placed on stock dividends has been applied in reduction of the book value of such investments.

During the period that this policy was in effect, the amounts included in income account at market value for stock dividends received but not sold comprised a substantial portion of the account. In Central States Electric Corporation, the amount represented as income from stock dividends received was more than 90% of the total reported as ordinary income for the period 1927–1935.

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incorrect on the basis of established accounting practice, is incorrect on the basis of any other consistent and reasonable scheme of accounting that can be suggested, is incorrect as a matter of economics, and should be incorrect as a matter of law.

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"The only remaining point to be considered is whether the treatment of stock dividends as income to the amount of the value of the stock when received would be in the general interest. I feel sure that it would not.

"Market values are affected by innumerable conditions, one of the most important of which may be monetary inflation. The result of this practice is to treat an increase in value due to monetary inflation as current income, analogous to interest and dividends based on actual earnings; and where the practice is adopted by a series of corporations, each one of which, except the first, holds stock in preceding companies, this effect of inflation is increased in geometrical progression. The practice seems to me to be fraught with the greatest danger to the whole financial structure. It involves inserting the thin edge of the wedge of unrealized increment into the income account. If such increment is to be treated as income, profits, or earnings, it should be recognized frankly that a fundamental revision of existing business accounting practice is being effected."

[132] Replies to the Commission's questionnaire for Central States Electric Corporation and American Cities Power & Light Corporation, Pt. II.

Central States Electric Corporation

Year	Amounts taken into income for stock dividends received from subsidiary [a]	Total amounts taken into income for stock dividends received	Total ordinary income including stock dividends received	Percent of total amounts taken into income for stock dividends received to total ordinary income
1927	none	$4,078,551	$4,241,519	96.15
1928	none	6,396,225	7,188,178	88.98
1929	$4,259,043	17,305,854	18,107,192	95.57
1930	2,880,132	11,604,203	12,634,233	91.85
1931	946,727	6,239,777	6,587,286	94.72
1932	none	2,232,138	2,355,812	94.75
1933	none	1,299,925	1,602,777	81.10
1934	none	364,445	1,012,585	35.99
1935	none	none	776,632	none
Total	8,085,902	49,521,118	54,506,214	90.85

[a] American Cities Power & Light Corporation, in which the holdings represented 68.40 percent at Dec. 31, 1929, 62.03 percent at Dec. 31, 1930, and 65.14 percent at Dec. 31, 1931, of the outstanding class B shares upon which the dividends were paid.

That portion of the above amounts taken into income representing stock dividends received from its subsidiary was not set forth separately in the company's published reports. The stock dividends received from the subsidiary in 1929 and 1930 constituted more than 24%, and in 1931 over 15%, of the total amounts taken into income for stock dividends received.

The summary indicates that the amounts taken into income account for stock dividends received from the subsidiary company totaled $8,085,902, representing a value placed upon approximately two-thirds of the total stock dividends issued. The issuing company itself charged the sum of $5,097,928 to operating surplus for all the shares issued as dividends. Applying two-thirds of this sum upon the portion held by its parent company, the amount is approximately $3,398,000. Central States Electric Corporation stated that its investments had been to a large extent in companies which pursued "the policy of paying dividends in stock, thereby financing in part the growth of their business through the reinvestment of their earnings." In this instance the earnings reinvested or capitalized by the issuing company applicable to the two-thirds of the stock held by the parent company, amounted to $3,398,000. However, this capitalized sum was increased about two and one-third times its size to $8,085,902 when the parent company entered these same dividend shares in its own income account.

The amounts entered in income account at market value for stock dividends received, but not sold, represented unrealized income. In the 1927–1928 period of rising values for securities, the danger inherent in the practice of taking into account unrealized income, at least as to that part which was in excess of the pro rata amount charged to earned surplus by the issuing company, was not readily perceived. The fall in market values of securities in subsequent years revealed the

weakness of this policy. In 1929, Central States Electric Corporation modified its practice by taking a "reduction in valuation of stocks acquired in 1929 as stock dividends, to December 31, 1929, market prices." In the published report, this reduction was shown from the amount which represented the earnings net after operating expenses, taxes, interest, and discount. Included in the earnings was an item of income reading "stock dividends, valued at market prices following respective dividend record dates."

In 1930, there was a further modification of the company's practice. Market values of stock dividends as at the dates of receipt were again reduced to market values as at the year end, but this reduced amount was utilized as a special appropriation "applied in reduction of book value of investments." In effect, the practice of entering in income account the amounts representing market value as at dates of receipt of stock dividends, were reduced to zero by two successive adjustments: first, the reduction to market value at the end of the year; and second, the special appropriation applied in full reduction of the market value at the year end. This procedure is seen in the following reproduction of the published income account of the company for the year 1930:

Central States Electric Corporation Income Account, Year 1930

Income:		
Stock dividends, valued at market prices following respective dividend record dates		$11, 604, 203. 80
Cash dividends and interest		1, 030, 029. 21
Profits realized on sale of securities (net)		4, 966, 354. 47
Total income		17, 600, 587. 48
Deductions:		
Interest and discount	$2, 578, 207. 96	
Taxes	474, 563. 80	
Operating expenses	328, 480. 37	
Total deductions		3, 381, 252. 13
		14, 219, 335. 35
Less: Reductions in above valuation of stock dividends to market prices at close of year, applied in reduction of book value of investments		5, 260, 951. 74
Balance of income before special appropriation		8, 958, 383. 61
Special appropriation of balance of above valuation of stock dividends, applied in reduction of book value of investments		6, 343, 252. 06
Net income carried to surplus		2, 615, 131. 55

The same method of accounting for stock dividends received was followed in the subsequent years up to and including 1934. No item appeared in the 1935 income account for stock dividends received.

Its subsidiary, American Cities Power & Light Corporation, followed the same plan of procedure for each year from 1928 to 1935,

except that the market value of the dividend shares at the year end was not reduced to zero until 1931. In the published report for this year it was stated:

Following the usual practice of the Corporation, stock dividends received, which have constituted the major part of its income, have been taken into the income account at a valuation based on market prices following the respective dividend record dates. In view, however, of prevailing conditions and the shrinkage in portfolio values for the time being indicated by current market quotations, it was decided to make special appropriations from the 1931 income, in reduction of the book value of investments, equal to the entire valuation ($2,054,315) so attributed to stock dividends received during the year. The result is that for the year there is carried from income account to operating surplus a credit of $769,645 which represents net cash income after eliminating all valuation of stock dividends received.

b. Open-End Companies

Of the 14 open-end companies reviewed, nine entered dividend shares at no valuation, while five companies followed the practice of disposing of dividend shares received from issuing companies regularly each period and entering the proceeds in income account, which proceeds were accounted for separately in published reports.[133] This latter method resembles the treatment of periodic stock dividends which are entered at time of receipt at market, with the distinction, however, that the amount shown in income account where the stock is not sold has not been realized in cash.

(1) MASSACHUSETTS INVESTORS TRUST AND DIVIDEND SHARES, INC.

The proceeds from the sale of stock dividends were substantial only in the cases of Massachusetts Investors Trust and of Dividend Shares, Inc.

As to Massachusetts Investors Trust, its declaration of trust provided for the inclusion of certain stock dividends in earnings:

While the trustees of Massachusetts Investors Trust shall otherwise have full discretion to determine which items shall be treated as earnings and which items as principal, they shall treat as principal any stock dividends received, except when any company establishes or has established the practice of paying annually or oftener stock dividends not exceeding ten percent (10%) per annum in lieu of, or in addition to cash dividends, in which cases the Trustees may in their discretion treat such stock dividends as earnings.

The certificate of incorporation of Dividend Shares, Inc., provided with respect to the treatment of regular dividends as follows:

All subscription rights, warrants, regular stock dividends and any rights and property received by the Corporation by way of income upon its investments shall be sold and the net cash proceeds of all such sales shall be credited to cash income * * *.

In both these companies, the accounting firm of Lybrand, Ross Bros. & Montgomery, in their certificates accompanying the financial

[133] The five companies which regularly included in income account the proceeds from the sales of stock dividends were: Bullock Fund, Ltd., Canadian Investment Fund, Ltd., Dividend Shares, Inc., Massachusetts Investors Trust, and Nation-Wide Securities Co.

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and operating statements of the said companies, made reference to the fact that the income accounts included proceeds from sales of stocks received as stock dividends, and referred to the provisions in the declaration of trust and in the certificate of incorporation upon which this treatment was based. As to Dividend Shares, Inc., Lybrand, Ross Bros. & Montgomery, in its certificate accompanying the financial statements of the company filed with the Commission in proceedings in connection with the registration of the company's securities,[134] stated specifically that the treatment "is not in accordance with the accounting practice generally followed with respect to such items":

> The entire net cash proceeds received from the sales of regular stock dividends and rights were included in income; these items may not be true income, but the practice is in pursuance of the provisions of the corporation's certificate of incorporation.
>
> Pursuant to a resolution of the Board of Directors, dividends declared are first charged against the net amount of capital surplus credited to distribution account, instead of first against earned income.
>
> The treatment of regular stock dividends and rights sold and dividends paid by the corporation as set forth in the two preceding paragraphs is not in accordance with the accounting practice generally followed with respect to such items. However, in view of the provisions in its certificate of incorporation, the accounting treatment followed by the corporation, in our opinion, appears acceptable under these circumstances.

In these instances, by provision in a declaration of trust or in a corporation charter, the accounting practice generally followed was supplanted by a procedure specified by the company itself—a procedure which was not acceptable generally.

C. Audits and Independent Accountants

1. ENGAGEMENT OF AUDITORS

The books of account of 59 of the 62 closed-end companies, and of all the 14 open-end companies under review, were audited by public accountants each year of the existence of these companies during the period under examination. The accounts of one closed-end company were not audited until 1934, and of another company, not until 1935, or some time after organization. Thus, by the end of 1935, 61 of the said 62 closed-end companies were examined by public accountants.[135]

2. RETENTION AND CHANGES OF AUDITORS

Of these 61 closed-end companies, each of 44 companies, or 72% of the number, retained the same accounting firm throughout the entire period under study. The accounting services for these 44 companies were provided by 18 firms, without being displaced, throughout the period. The remaining closed-end companies (17 or

[134] Certificate dated July 20, 1936, File No. 2–2397.

[135] The closed-end company of the group under study whose books of account were not audited by public accountants was Crum & Forster Insurance Shares Corporation.

about 28% of the number) changed from one firm of accountants to another. Sixteen of these companies made only a single change, while one company changed accounting firms twice. Giving effect to the shifting of accountants by these 17 companies, the 61 closed-end companies were represented by 20 firms of public accountants. However, three of these accounting firms provided services for 30, or about 50% of the companies, while six other accounting firms audited the books of 20, or approximately 32% of the entire group. Thus, nine accounting firms audited the accounts of 50, or 82% of the companies studied. Eleven other accountants each audited the records of one of the remaining 11 companies.

As to the 14 open-end companies under review, 11 retained the same accounting firms throughout the period to 1935, while three companies made changes in accountants. After the shifts, three accounting firms were acting as auditors of all 14 companies with two of the firms auditing six companies each, while one accounting house audited two companies.

a. Oils & Industries, Inc.

The case of Oils & Industries, Inc., is an instance of conflicting points of view between the management and accountants which resulted in displacing the firm of accountants in favor of another whose views conformed with those of the management.

The minutes of a meeting of the board of directors of Oils & Industries, Inc., formerly Oil Shares, Incorporated, dated May 11, 1931, recited: [136]

> The President stated that the principal business to come before the meeting was the consideration of revision of the form of the financial statements to give effect to the Amendment recently made to the company's Charter, and the resolution of the Executive Committee at its meeting on May 7, 1931, recommended for passage by the Board. The President stated further that the company's auditors, Price, Waterhouse & Company, had declined to approve the financial set-up in the way in which counsel had advised him was legal and proper in view of the Amendment referred to. Mr. Kelsey (counsel of the company), at the request of the committee, thereupon gave his views on the subject and in connection therewith submitted a letterhead received from Lybrand, Ross Bros. & Montgomery, dated May 11, 1931, supporting the form of setting up proposed by the President and approved by Mr. Kelsey's firm. Mr. Kelsey advised the Committee that in his opinion there was no question as to the legality of the set-up as stated in the letter referred to. * * *
>
> After further discussion, on motion duly made, seconded and unanimously passed, the President was authorized to dispense with the services of Price, Waterhouse & Company, in case, after further negotiations, they should refuse to alter their position as above referred to with respect to applying profits realized over the write-down values of the portfolio and to employ Lybrand, Ross Bros. & Montgomery, or some other internationally well-known auditors.

Lybrand, Ross Bros. & Montgomery specified their preference for one of the two methods of treatment set forth in the letter. It is evident from the minutes reproduced above that the preference expressed by this accounting firm in the letter was in agreement with that of the

[136] Public Examination, Oils & Industries, Inc., Commission's Exhibit No. 1527.

management and that the viewpoint of Price, Waterhouse & Co. with respect to the handling of write-downs and the treatment of the excess of sales receipts over the written down value conflicted with the opinion of the management of Oils & Industries, Inc. Price, Waterhouse & Co. was displaced by Lybrand, Ross Bros. & Montgomery whose views accorded with the management's.[137] David C. Johnson, representing Oils & Industries, Inc., when examined upon this change of accountants, testified:[138]

* * * The minutes show that there was some dispute between the company and Price, Waterhouse, who were then accountants, as to the form of the new balance sheet and also show that Lybrand, Ross Brothers & Montgomery were consulted and advised that the form desired by the directors was correct. It further showed at that time Price, Waterhouse was discharged and Lybrand, Ross Brothers & Montgomery employed.

The question raised before was the point which Price, Waterhouse had raised about the balance sheet. I talked with Mr. O'Neal, I think his name is, who is one of the partners of Price, Waterhouse, about this, and he said in his opinion it wasn't only the question of the balance sheet but there was and had been various disagreements between the directors and Price, Waterhouse, and this was the accumulation of it and he really thought they were taking advantage of it to get rid of them.

3. SCOPE AND FREQUENCY OF AUDITS[139]

a. Scope of Audits

It has been stated that[140]—

* * * The function of the independent certified public accountant is to examine a concern's accounting records and supporting data, in certain matters to obtain outside confirmations, and to require and consider supplementary explanations and information from the management and employees to the extent necessary to enable him to form an opinion as to whether or not the financial statements as submitted present fairly the position and the results of periodic operations.

An audit which would embrace an examination of each material detail of every accounting transaction is now often referred to as a "detailed audit." The audit generally undertaken among investment companies during the period under review was one which was between such a detailed audit, on the one hand, and an audit which was confined to a verification of the items appearing on the balance sheet and which did not encompass the profit-and-loss statement, on the other hand. However, it may be said that the boundaries of the field

[137] The text of the letter from the accounting firm of Lybrand, Ross Bros. and Montgomery, dated May 11, 1931, referred to in the foregoing minutes, is contained in Sec. B, 3, supra.

[138] Public Examination, Oils & Industries, Inc. (formerly Oil Shares Incorporated), at 14873.

[139] See also infra, pp. 2096–98.

[140] *Extensions of Auditing Procedure,* American Institute of Accountants, October 1939.

of examination and investigation which the unrestricted scope of audit covers have not as yet been defined exactly.[141]

Of the 61 closed-end companies audited by outside accountants, 58 had audits which were described as "complete," "detailed," and "balance-sheet and general audit," while two companies had only balance-sheet audits, audits which were confined solely to a verification of

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[141] In an address on September 21, 1939, before the annual meeting of the American Institute of Accountants, William W. Werntz, Chief Accountant of the Securities and Exchange Commission, further stated:

"The second point I have listed is that an audit of the business has been made. Samuel Broad recently stated in the hearings regarding McKesson and Robbins that 'the primary purpose of an accountant's examination for a company which issues financial statements is to satisfy himself that the financial position and earnings are fairly stated.' This view was affirmed by the other witnesses called to the stand. Obviously, there is implicit in any such view the assumption that the auditor has satisfied himself by appropriate means that there is a business of approximately the character which the statements being certified purport to reflect. At a great many points in the audit varying degrees of knowledge about the business being conducted are essential to an intelligent review of the statements and accounts. It is perhaps unnecessary to emphasize the importance which economic and business facts have in allocating costs and profits to particular periods. All of these and, in addition, the administrative organization and personnel have direct bearing on the system of internal check and control and the extent to which reliance thereon is justified. The examination of certifying accountants, although in the main concerned with financial records, cannot be confined to them.

"It seems to me that the examination which an investor is entitled to expect of certifying accountants must be such as will reasonably establish, by adequate means, the authenticity of the transactions and the accuracy of the records of those transactions. This must be done by tests to check the results shown by the records against each other, against physical facts, against the records of subsidiaries and affiliates, and against information obtained from unaffiliated persons with whom the company does business. It has been urged that adequate reconciliation of cash on hand and bank balances is sufficient to establish authenticity of all accounts because of the key position which bank transactions play in normal business life. Disregarding the possibilities of manipulating or falsifying such transactions and of short circuits in which cash is not involved, it would seem that this is a slender base upon which to rest the authenticity of the entire accounts and statements. In contrast, many have urged that knowledge of the business should be obtained to a considerable degree by first-hand observation, and it is common practice for accountants to employ procedures which involve activity by independent third parties. It is perhaps true that the attention which events have directed toward standardizing accounting principles has resulted in less attention to audit problems. It is as a corrective to this possibility that the recent resolutions of your Institute and the discussions about them have to my mind lasting significance.

"It may be worth pausing a moment at this point to consider the bearing which the present resolutions have on this topic. I would like first to consider the importance to be attached to the system of internal check and control. As companies expand, it is hardly necessary to say that their transactions and records become so voluminous as to preclude an examination of all transactions. Perforce, the company must establish a routine and the auditor under normal conditions must rely upon it. To justify reliance it is implicit that the auditor thoroughly inspect the system; first, to see whether in principle it should produce reliable results; second, to see whether it is operating as it was set up to operate; and, third, to see whether it is, in fact, producing accurate and reliable results—this latter by tests of the records against themselves, against the documents which are the grist of the mill, and against physical facts and independent sources. Only to the extent these tests give positive results is the auditor justified in relying on a sampling process as the basis for an informed opinion."

Also upon this question of the breadth of the task of accountants when conducting an audit, Jerome N. Frank, Chairman of the Securities and Exchange Commission, stated in an address on October 10, 1939, before the eighth annual meeting of the Controllers' Institute of America, as follows:

"One thinks at once of a recent notorious case, in which crooked management went on for years, undetected by the auditors. Without here passing on the merits of the work done

the items appearing on the balance sheet, throughout the period under review. One other company was under this kind of limited audit until 1935, when it was abandoned in favor of the general type. All 14 open-end companies reported that the audits of their accounts were "complete" or "general." [142]

It is not clear that these audits included a verification of cash and securities by inspection or certificates from depositaries. Upon an examination of that part of the accountants' certificates appended to the published annual reports to stockholders which referred to the scope of the accountant's audit, it was found that a large number failed to refer to any confirmation of cash balances or to any verification of portfolio securities.[143] Thus in these numerous instances it cannot be stated as a certainty that the audits included a proper confirmation and adequate verification of the items of cash and portfolio which comprise the largest portion of the assets of investment companies.

b. Frequency of Audits

The frequency with which audits of investment companies were made are tabulated in the following summaries with respect to the 61 closed-end and the 14 open-end companies (See Table 54):

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by them in the light of accounting standards then prevailing (for I want to indulge in no hindsight judgments), it may fairly be said that from that case we may derive these observations as to standards which should *hereafter* be applicable: Accountants should not undertake to make a report unless, before doing so, they have become sufficiently familiar with the business of the company to give them a background for their work, a basis for determining of what their work must consist, and a basis for appraising the company's operations. Those in charge of the audit should have had adequate business experience and should inform themselves generally as to the industry so as to make pertinent comparisons of the company under examination with the industry as a whole. One of the important factors they must consider is the reliability of the company's own internal accounting and auditing procedure. In doing so they should be greatly concerned not only with the blueprints of the system of internal check and control—the purported system—but also with the system that is in actual operation—with the system in action and not merely on paper. Consideration of these factors is necessary in determining the character that their examination must take. Finally, the examination made ought not to exclude from its scope the management of the company. In this sense auditing procedure is as important as the application of appropriate accounting principles, since unhappy experience has underlined the obvious in showing that unless the principles are applied to authentic and accurately reported transactions the results are false."

[142] Audits have not yet been classified into fixed and unequivocal divisions. Therefore it must be understood that the terms as quoted above to describe the scope of audits of investment companies are those contained in the answers to the Commission's questionnaire and that the significance of these answers is limited to the general meanings this terminology had in the period under review—1927 through 1935. It is evident that the term "balance sheet audit" was used in the answers to the questionnaire to indicate a restricted audit. Today this term seems to indicate the type of examination used as a basis for certification under the Securities Act of 1933 and the Securities Exchange Act of 1934. Also the terms "detailed" and "complete" as contained in the answers to the Commission's questionnaire, are to be construed less broadly than that given to them today.

[143] For the results of this examination, see infra, pp. 2096–98.

TABLE 54.—*Frequency of audits of 61 closed-end investment companies, 1927–1935*

	Year of change	Number of companies
Annually, consistently		27
Annually, with minor exceptions		2
Semiannually, consistently		7
Quarterly, or more frequently, consistently		1
Changed from annually to semiannually	1930	3
	1931	1
	1933	2
	1934	1
	1935	1
		8
Changed from annually to quarterly	1930	3
	1931	1
	1932	2
	1935	2
		8
Changed from semiannually to quarterly	1934	2
	1935	1
		3
Changed from quarterly to semiannually		1
Changed from quarterly to monthly		1
Changed from annually to semiannually (1929) and then to quarterly (1930)		1
Changed from no audits to annual audits		2

A trend toward more frequent audits is indicated. (See Table 55.) Thus, 21 companies changed to more frequent audits. However, 31 companies, or 51%, still submitted to an annual audit only. As at the close of the fiscal year 1935, the frequency of audits of the closed-end companies was as follows:

TABLE 55.—*Frequency of audits of 61 closed-end companies for the fiscal year 1935*

	Number of companies	Percent
Annually	31	51
Semiannually	16	26
Quarterly, or more frequently	14	23
Total	61	100

With respect to open-end companies, Table 56 summarizes the frequency of audits:

TABLE 56.—*Frequency of audits of 14 open-end investment companies, 1927–35*

	Number of companies
Annually, consistently	4
Semiannually, consistently	6
Quarterly, consistently	3
Changed from annually to quarterly (1931)	1

4. DATE OF CLOSE OF FISCAL YEAR

Of interest in connection with audits of the accounting records of investment companies, is the fact that December 31 is the fiscal year-end of the bulk of the closed-end and open-end companies reviewed as shown below in Table 57:

TABLE 57.—*Date of close of fiscal year of investment companies*

Closed-end companies	Number of companies	Open-end companies	Number of companies
Dec. 31	53	Dec. 31	10
Jan. 31	1	Mar. 31	1
Feb. 28	3	Sept. 30	1
May 31	2	Oct. 15	1
June 30	2	Nov. 30	1
Aug. 31	1		
			14
	62		

D. Reports to Stockholders

The reliability of the company's report to its stockholders depended upon the consistent adherence to accepted principles of accounting, and the extent to which the management, in a new and unusual situation, adopted a conservative accounting viewpoint in the selection of an accounting procedure from various accounting procedures, none of which had as yet become established as the accepted method. Therefore, the published reports assumed first the character of the accounting practices and procedures which were utilized in recording and reflecting the results of the company's activities.

The reports issued by investment companies to their shareholders, more particularly reports published after the completion of the audit at the close of the fiscal year, were examined especially from the viewpoint of the stockholder who must rely upon these reports for information upon the activities of the management.[144]

[144] William W. Werntz, Chief Accountant of the Commission, in an address on September 20, 1939, pertaining to: "Subjects for Accounting Research," before the annual meeting

The section analyzes reports to stockholders particularly with respect to matters peculiar to investment companies, such as disclosure with respect to their portfolios, their operations, liquidating value of capital shares, brokerage commissions, management fees, and salary disbursements.

Other important phases directly affecting the efficacy of reports to stockholders have been dealt with elsewhere in this chapter, such as the degree of disclosure with regard to reserves, and with respect to the bases utilized for the computation of profits or losses upon sales of securities. The treatment in stockholders' reports of the company's own reacquired stock has also been discussed. The introduction to this chapter provides a summary of those topics dealt with elsewhere which affected the standard of reports submitted to stockholders.

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of The American Institute of Accountants, discussed the importance of regarding the interests of the investor in the preparation of the reports to stockholders as follows:

"I want first to speak of some fundamental concepts. It is not criticism to point out that accounting developed as an instrument designed to aid managers in determining how best to conduct their affairs, in competition with other managers, so as to obtain their share of capital and credit as well as business. These managers were largely owners, or personal agents of owners. This is still one of the principal functions of accounting. With the growth of public investment in business and the divorce of ownership from control, however, it became necessary for managers who were not owners to report to investors who were not managers and had not the intimate knowledge of managers. At hand, for this purpose were the internal reports prepared for the management, which, when condensed, were accepted as an adequate means of transmitting information. Consequently, the report to stockholders took the form in most instances of a drastically abridged edition of the report to the management, and often conveyed little of the information so essential for an intelligent investor's understanding of the activities of the business. Subsequent development has been mostly along the lines of additional disclosure and consistency of treatment. I doubt whether anyone has reexamined from stem to stern the whole philosophy of accounts and accounting practice with but one thing in mind, the interests of public investors.

"Much effort has been expended with the object of determining what is correct or sound accounting. On the other hand, some have urged that the soundness or correctness of an accounting practice is determinable only on the facts of the particular situation; that circumstances alter cases. In this view of the problem, the point at issue is what are the relevant facts, for presumably in identical cases different conclusions are not possible. Under either approach, the time has come when the effect of alternative accounting practices on the interests of public investors must be given explicit consideration before reaching a decision. It is not to be implied that bringing the investors' interests into a position coequal with that of management or the taxing authority will result in wholesale changes and radical innovations in accounting methods. Instead, it represents the introduction of an additional independent approach—whether the problem at issue be the formulation of accounting theory or the determination of the best way to interpret a particular set of facts.

"So far I have had reference only to accounting principles and the appraisals of alternative procedures, such as depreciation and retirement accounting, the treatment of discount on refunded issues, the basis of valuing various assets, and the allocation of income and expense to various periods. The same considerations apply to the methods of reporting information. Today, inclusion in financial reports of a balance sheet and income and surplus statements is accepted practice. There have been many advances in disclosure, such as greater break-down of major captions, separate display of reserves, and more information in the income statements. In some instances other statements are included, such as computations of net-asset values in the case of investment trusts, historical records of earnings, summaries of changes during the year, and the like. It may well be, however, that giving full play to investors' interests might lead to major changes in the traditional statements or to new forms of statements."

1. FREQUENCY OF REPORTS TO STOCKHOLDERS

For the year 1935, of the group of 60 closed-end companies [145] under examination, 19 companies issued annual reports, 21 companies issued semiannual reports, 18 issued quarterly reports, and two issued reports in that year covering miscellaneous periods, as shown in Table 58.

TABLE 58.—*Frequency of reports to stockholders of 60 closed-end investment companies for the period 1927–35*

	Year of change	Number of companies
Annually, consistently		19
Annually, with quarterly and semiannual reports during some years		2
Semiannually, consistently		8
Quarterly, consistently		4
Changed from annually to semiannually	1930	2
	1931	4
	1932	1
	1933	3
	1934	1
	1935	1
		12
Changed from annually to quarterly	1930	1
	1931	1
	1934	2
	1935	1
		5
Changed from semiannually to quarterly	1930	2
	1931	2
	1934	3
	1935	1
		8
Changed from quarterly to semiannually	1930	1
Changed from annually to semiannually, 1933, then to quarterly, 1934		1

Open-end companies issued reports more frequently (although only to a slight extent) than did the closed-end companies. (See Table 59.) In 1935, approximately two-thirds of the closed-end group issued reports more frequently than annually, while about three-fourths of the open-end group issued reports more often than once a year.

[145] Two closed-end companies of the 62 examined published no reports. due to the small number of their stockholders, so that the statistics in this section relate to 60 closed-end companies and to 14 open-end companies. Except for the table which indicates the frequency of reports to stockholders, all other tabulations treat only with the year-end publications.

Table 59.—*Frequency of reports to stockholders of 14 open-end companies during the period 1927–35*

	Year of change	Number of companies
Annually, consistently		3
Semiannually, consistently		4
Quarterly, consistently		4
Changed from annually to semiannually	1935	1
Changed from annually to quarterly	1930	1
	1933	1
		2

During the period from 1927 to 1935, three companies changed to more frequent reports, so that at the end of the period the companies were issuing reports as shown in Table 60.

Table 60.—*Frequency of reports to stockholders of 14 open-end companies for the fiscal year 1935*

	Number of companies
Annually	3
Semiannually	5
Quarterly	6

2. BALANCE SHEETS, OPERATING STATEMENTS, AND ANALYSES OF SURPLUS ACCOUNTS IN ANNUAL REPORTS

Each annual report of the 60 closed-end and 14 open-end companies included a balance sheet. For the fiscal year, 1935, an operating statement was included in the annual report of each of the 60 closed-end companies, with one exception. However, four companies originally omitted operating statements from annual reports but subsequently included these statements.

Of the 14 open-end companies, 11 included operating statements consistently, one company included these statements occasionally, while two organizations (Investment Trust Fund B, after 1929, and Investment Trust Fund A, after 1931) discontinued presenting the items comprising net ordinary income in statement form, but included them in the comments. These Funds, however, failed to furnish analyses of undistributed income accounts.

At the end of 1935, all 60 closed-end companies presented analyses of earned surplus accounts in reports to stockholders, but three of this group omitted analyses of capital surplus account. The number of companies whose published reports contained complete analyses of surplus accounts increased from 46, prior to 1929, to 57, at the end of 1935. (See Table 61.)

TABLE 61.—*Inclusion of analysis of surplus accounts in annual reports of 60 closed-end investment companies, 1927–1935*

	Year of change	Number of companies [a]
Included, consistently		46
Included for later years	1929	2
	1930	1
	1931	1
	1933	1
	1935	2
		7
Included, consistently with respect to earned surplus; included for later years with regard to capital surplus	1931	3
	1933	1
		4
Included, consistently, for earned surplus, and not for capital surplus		2
Included for later years with regard to earned surplus, after 1930; not included with regard to capital surplus		1

As to the 14 open-end companies, 10 furnished complete analyses of surplus accounts prior to 1931, two furnished these analyses in later years, but two others excluded such analyses—Investment Trust Fund A, after 1930, and Investment Trust Fund B, after 1931. (See Table 62.)

TABLE 62.—*Inclusion of analysis of surplus accounts in annual reports of 14 open-end companies*

	Year of change	Number of companies
Included, consistently		10
Included for earlier years; not included for later years	1930	1
	1931	1
		2
Included consistently as regards undivided earnings; complete analysis of surplus given in later years	1932	1
	1934	1
		2

a. Incorporated Investors

Incorporated Investors, an open-end company organized in 1925, did not submit an analysis of the surplus account in its published reports until 1934. Thus, realized losses for the 1930–1933 period, aggregating $21,870,551, which were charged to surplus account, were not disclosed. So, too, unrealized losses for the period 1930 through 1933, amounting to $5,926,041, due to the readjustment of the year-end portfolios to the lower of cost or market values via an undisclosed reserve account were not revealed in these reports.[146] In all,

[146] See review of portfolio reserve of Incorporated Investors, supra, p. 1972.

investment losses during this period aggregating $27,796,592, as summarized below, were not revealed to stockholders except that the decrease in surplus account might have indicated that losses had been suffered.

Year	Net losses on sales of securities charged to surplus account	Additions to or (deductions) from reserve for depreciation at year-end revaluations based on lower of cost or market values	Total losses (gains) undisclosed to stockholders
1930	$2,537,560	$13,200,749	$15,738,309
1931	7,431,876	5,014,742	12,446,618
1932	9,902,317	(6,755,406)	3,146,911
1933	1,998,798	(5,534,044)	(3,535,246)
Total	21,870,551	5,926,041	27,796,592

b. Investment Trust Fund A and Investment Trust Fund B

Investment Trust Fund A, an open-end company, included an analysis of undistributed income account in its published reports to December 31, 1930. The practice was discontinued during the period 1931 to 1933, but was resumed after 1933. By omitting the analysis of undistributed income account from 1931 to 1933, the management did not publicize the following record of trading losses reflected in that account:

Year ended December 31:	*Losses on sales of securities*
1931	$3,267,896.04
1932	4,366,439.84
1933	1,059,261.44

Investment Trust Fund B, also an open-end company, discontinued the practice of including an analysis of its undistributed income account beginning with the annual report of September 30, 1932. By excluding the analysis of this account from the reports subsequent to that date, Investment Trust Fund B did not disclose its record of trading losses carried in that account.

Year ended September 30:	*Losses on sales of securities*
1932	$1,895,283.40
1933	606,102.73
1934	75,872.60

c. Blue Ridge Corporation

An analysis of capital surplus account included in the 1929 annual report of Blue Ridge Corporation illustrates the nondisclosures which may result from grouping unrelated items under a single heading and indicating amounts as net after deductions, without disclosing the amount of the deductions.

At December 31, 1929, the balance of capital surplus account of this company was $34,638,210.52. An analysis of this account follows:

Analysis of capital surplus account of Blue Ridge Corporation to December 31, 1929

Item No.	CREDITS		
1.	Excess of consideration received (cash and securities) over par or stated value of capital stocks issued therefor	$45,016,966.50	
2.	Share of underwriting profit on sale of own capital stocks	480,014.67	
3.		45,496,981.17	
4.	Less: Commission paid to Manufacturers Trust Co. for underwriting preference and common stocks	541,962.13	
5.			$44,955,019.04
6.	Donation by Shenandoah Corporation of 2,000 shares of Knickerbocker Corporation capital stock [147] valued on the basis of its sole asset consisting of 1,300,000 shares of Central States Electric Corporation common stock. These 1,300,000 shares were carried on the books of Knickerbocker Corporation at $417,820 on the basis of cost to company from which security was acquired		29,087,500.00
7.	Excess of par and/or stated value over cost of 74,200 shares of preference stock retired		1,226,815.00
8.	Excess of stated value over amount capitalized in respect of common stock issued in payment of preference dividends		23,513.61
9.	Restoration to surplus from a certain reserve		9,754.87
10.	Total credits		75,302,602.52
	CHARGES		
11.	Reserve established Nov. 30, 1929, to reduce valuations of investments to market quotations as at Nov. 27, 1929		[148] 35,772,618.00
12.	Reserve established Nov. 30, 1929, to reduce valuation of holdings in common stock of Central States Electric Corporation to give effect to adjustment due to holdings by that company in capital stock of parent, Shenandoah Corporation		[148] 4,891,774.00
13.	Net losses on sales of securities	$2,332,550.56	
14.	Less: Charged to reserve for securities	2,332,550.56	
15.	Total charges		40,664,392.00

In the "Annual Report to the Stockholders" for the period from the organization of the company on August 12, 1929 to December 31, 1929, the following "Statement of Capital Surplus—December 31, 1929" was included (except for the item numbers):

Item No.			
1.	Value of consideration received for capital stock issued in excess of amount capitalized with respect thereto		$44,955,019.04
2.	Amount transferred from operating surplus upon issuance of common stock as dividends		23,513.61
3.	Total		44,978,532.65
4.	Deduct: Reserve applied as of Nov. 30, 1929, in reduction of book value of investments, other than syndicate participations, to market prices as of that date	$35,762,863.13	
5.	Less: Net credit arising from acquisition of 74,200 shares of preference stock of the corporation, retired to Dec. 31, 1929, and of other securities	25,422,541.00	
			10,340,322.13
6.	Balance Dec. 31, 1929, per balance sheet		34,638,210.52

This published abridgment did not disclose the following material facts: Item 1 of the published account was a consolidation of items 1 to 4, inclusive, of the analysis per books. As a result, the

[147] These 2,000 share were donated by New Empire Corporation to Central States Electric Corporation, which donated them to Shenandoah Corporation, which donated them to Blue Ridge Corporation.

[148] See supra, pp. 1980–84, with respect to the failure to disclose the essential details and composition of this reserve in the published report for the year ended December 31, 1931.

stockholders were not informed (a) of the share of underwriting profits amounting to $480,014.67 obtained from the sale of the company's own stock, and (b) of the commissions of $541,962.13 paid to Manufacturers Trust Co. for underwriting the issues of preference and common stocks.

Item 5 of the published account was comprised of items 6 and 7 of the book account, less item 12, viz:

Donation by Shenandoah Corporation of 2,000 shares of Knickerbocker Corporation capital stock	$29,087,500
Excess of par and/or stated value over costs of 74,200 shares of preferred stock retired	1,226,815
Total	30,314,315
Less reserve established to reduce valuation of holdings in common stock of Central States Electric Corporation	4,891,774
Balance, published as "Net credit arising from acquisition of 74,200 shares of preference stock of the Corporation retired to Dec. 31, 1929, and of other securities"	25,422,541

The inadequacy of the descriptive material is plainly apparent. The donation of the 2,000 shares of Knickerbocker Corporation stock, to which was assigned the value of $29,087,500, was described merely as "other securities," although the item was created from this donation almost entirely. If information had been provided that this valuation of $29,087,500 was upon the basis of the sole asset of Knickerbocker Corporation of 1,300,000 shares of Central States Electric Corporation stock carried on the books of Knickerbocker Corporation at $417,820, the stockholders of Blue Ridge Corporation would have been in a better position to treat with the valuation of $29,087,500.[149] The failure to reveal the composition of the published amount resulted in a nondisclosure that the credit arising from the reacquisition of 74,200 capital shares was merely $1,226,815, that the credit arising from the donation was the substantial sum of $29,087,500, and that the reserve which was established to reduce the valuation of the holdings of Central States Electric Corporation common stock amounted to $4,891,774.[150]

The net losses on sales of securities amounting to $2,332,550, which were charged first to capital surplus account and then transferred

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[149] For a discussion of the factors affecting the value of the securities of Central States Electric Corporation, see ch. V of this part of the report, pp. 1683–1708.

[150] The comments in the published report contained the following information, but this information also is deficient in the respects pointed out above:

"As of November 30, 1929, a reserve of $35,762,863 was created by appropriation from capital surplus and applied to reduce to then market prices the book value of investments, other than syndicate participations not then terminated. On the other hand, the acquisition and retirement by your Corporation of the Preference Stock mentioned above and the acquisition of a large block of Common Stock of Central States Electric Corporation upon terms representing, in effect, a substantial contribution to capital, resulted in an important addition to net assets. The aggregate market value (less reserve for cross-holdings) of such stock of Central States Electric Corporation plus the total par value of Preference Stock retired, exceeded the combined cost thereof by $25,422,541. This capital gain has offset to that extent the appropriation from capital surplus mentioned above.

"In any case where the Corporation has a substantial interest in common stock of an affiliated company which in turn has a substantial interest in the Common Stock of this Corporation, your Directors consider it prudent and conservative to value the common stock of such affiliated company below market by the amount of a reserve estimated to adjust the effect of such cross-holding of stock. This reserve will be revised periodically in accordance with a definite formula adopted to accomplish such adjustment. In the valuation of net assets of the Corporation, wherever mentioned in this report, reserves for cross-holdings accordingly have been deducted from market values."

With regard to this cross-holding reserve, see discussion of its later history, supra, pp. 1981–82.

as a charge to the portfolio reserve (shown as items 13 and 14 of the book analysis), were not disclosed in the published account. Stockholders may have been misled by the fact that the trading result for the period as published in the "Statement of Income," was a "Profit realized on sale of securities (net) $499,370.37"; whereas, had the unreported loss of $2,332,550 been applied to the published profit of $499,370.37, a net realized loss of $1,833,179.63 would have been indicated.

3. DISCLOSURE OF PORTFOLIO SECURITIES

The portfolio of securities of an investment trust constitutes its principal asset. See Table 63 for a review of the reports issued by the companies selected in the sample group to ascertain the extent to which details of investments in securities were submitted to stockholders.

TABLE 63.—*Inclusion of list of portfolio securities in reports to stockholders by 74 investment companies, 1927–35*

	Year of change	Number of companies
Closed-end companies:		
Included consistently		30
Included in later years	1928	1
	1929	5
	1930	7
	1931	1
	1932	1
	1933	2
	1934	4
		21
Important holdings for early years disclosed and complete list for later years		2
Included in some years, and not in others		2
Not included consistently		5
Total		60
Open-end companies:		
Included consistently		12
Included in later years	1928	1
	1933	1
		2
Total		14

One-half of the group of 60 closed-end companies were consistent in submitting a list of portfolio securities with reports to stockholders. The practice of submitting lists of investments became more prevalent, and for the fiscal year 1935, 55 of the 60 in the group adopted the policy of publishing portfolio lists. All of the open-end companies in the sample group by the end of 1935 disclosed in their annual reports the securities contained in their portfolios. However, the information furnished when these lists of securities were submitted was insufficient in certain respects in the cases of

most of the companies. The lists were deficient in failing to reveal such details as the number of units, and the cost and market, or other fair value, of the securities held.

4. DISCLOSURE OF MARKET OR FAIR VALUE OF PORTFOLIO SECURITIES

The disclosure of the aggregate market or fair value of securities in addition to the disclosure of cost value, as at the date of the financial statement, customarily is made in a parenthetical note to the item to which it refers or as a footnote to the balance sheet.[151] This information is obviously indispensable to any determination of the net worth of the company and of the net asset or liquidating value of the shares. In the early part of the period under study, the stockholders of some of the companies were denied these essential facts. In these instances, where an amount of appreciation in the value of the portfolio had not been disclosed, this amount was in the nature of a hidden reserve, and where the amount of depreciation was not revealed, the balance sheet was virtually uninformative. In either case, the outside stockholder was put under a severe handicap as against the insider. In time, all the companies within the group studied, except one, provided this information, and two companies furnished this information only as to listed securities (Table 64).

TABLE 64.—*Disclosure of market or fair value of portfolio securities by investment companies in reports to stockholders, 1927–35*

	Year of change	Number of companies
Closed-end companies:		
Disclosed consistently		42
Disclosed in later years	1928	1
	1929	1
	1930	9
	1932	1
	1934	1
	1935	1
		14
Disclosed consistently as to general investments; disclosed in later years as to investments in affiliates		1
Disclosed as to listed securities only		2
Disclosed in earlier years only		1
Total		60
Open-end companies:		
Disclosed consistently		12
Disclosed in later years, after 1929		1
Disclosed occasionally		1
Total		14

[151] In cases where the portfolio was carried at the lower of cost or market, the higher figure generally was shown parenthetically.

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Incorporated Investors, an open-end company, disclosed market value only intermittently during the period under review. Its practice was as follows: 1927 and 1928, cost value only; 1929, cost and market value; 1930, 1931 and 1932, lower of cost or market value only; and 1933, 1934, and 1935, cost and market value.

The significance of "market value" was indicated in the testimony given by Franklin Bowman, a member of the accounting firm of Haskins & Sells, in connection with a discussion of the audit reports of Eastern Utilities Investing Corporation. In the accountants' report as of December 31, 1931, the value of the securities in the portfolio was shown at "market value." Subsequent to 1931 the corresponding value of investments was qualified in the accountants' reports as "value based on market quotations." It was indicated further that those quotations were based on nominal transactions. Mr. Bowman testified:[152]

> As a matter of fact we have changed our practice of saying that securities have a market value of a certain amount because we recognize that a market quotation does not give a security a "market value." We preferred the expression "those based on market quotations." We think it is different from using "market value."

Mr. Bowman further testified that:

> It is more informative if you have a large block of securities and the quotations are based on nominal transactions, to say so [in the reports].

In arriving at the value of investments, liquidating values as against current market values were used by some companies as a basis of valuation. During 1934, Home and Foreign Securities Corporation acquired a substantial portion of the outstanding stock of Oils & Industries, Inc., an investment company. The liquidating value, based on the market value of the underlying securities, exceeded the market quotations of the stock of Oils & Industries, Inc. In the financial statements published by Home and Foreign Securities Corporation the liquidating value instead of market quotations was used in evaluating the investment.[153]

a. Liberty Share Corporation

In Liberty Share Corporation, organized April 2, 1929, the published report did not accurately disclose the market or fair value of portfolio securities and included the company's own stock in the portfolio securities without disclosure to stockholders. The first and only annual report issued to the stockholders, which included an independent auditor's certificate, was the one published for the year 1935.[154] For the years 1929, 1930, 1932 and 1934, these annual reports were in the form of letters signed by Philip H. Gerner, first as executive vice president and later as president of the investment company. For the years 1931 and 1933, no reports were sent to stockholders.

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[152] Public Examination, Eastern Utilities Investing Corporation, at 24619–20.

[153] Annual report for the year ended June 30, 1934, for Home and Foreign Securities Corporation.

[154] Reply to the Commission's questionnaire for Liberty Share Corporation, Pt. IV, Item 25, and Pt. I, Item 1 (h).

In the report for the year ended December 31, 1930, the total assets of the investment company were stated to be $18,550,178.64,[155] while its books disclosed the total assets for that year-end to be $14,417,268.59,[156] a difference of $4,132,910.05. A comparison of the figures contained in the books and the annual statement for the year ended December 31, 1930, is as follows:

	Books of the investment company	Report to stockholders
ASSETS		
Cash	$158, 100. 18	$158, 100. 18
Accounts and notes receivable	6, 446, 923. 85	6, 451, 728. 83
Investments at cost	7, 784, 065. 56	[a] 11, 907, 593. 72
Furniture and fixtures	28, 179. 00	32, 755. 91
Total	14, 417, 268. 59	18, 550, 178. 64
LIABILITIES		
Capital and surplus	5, 990, 111. 29	10, 118, 444. 43
Accounts and notes payable	8, 355, 189. 77	8, 355, 189. 77
Reserves	71, 967. 53	76, 544. 44
Total	14, 417, 268. 59	18, 550, 178. 64

[a] "Market or appraised value as of Jan. 10, 1931, $9,536,769.68,[157] evidencing a book value per share of $15.58 on the 497,292 shares outstanding."

[155] Public Examination, Liberty Share Corporation, Commission's Exhibit No. 876.

[156] Id., Commission's Exhibit No. 878.

[157] This figure of $9,536,769.68 was arrived at by appraising its own stock and stocks of affiliate companies at figures far exceeding their actual market value. It will be noted that the company's own stock is included among the assets:

Company	Number of shares	Appraisal per share	Appraised value	Market per share	Market value
Liberty Bank of Buffalo	5, 970	$215	$1, 283, 550. 00	$158	$943, 260. 00
Liberty Share Corporation	42, 123	72	2, 912, 699. 17	17	726, 091. 00
Western New York Securities Corp	50, 000	20	1, 000, 000. 00	13	650, 000. 00
Western New York Securities Corp	4, 567	13	59, 371. 00	13	59, 371. 00
Other stocks			3, 887, 529. 51		3, 887, 529. 51
Bonds			393, 620. 00		393. 620. 00
Appraised value			9, 536, 769. 68		6, 659, 871. 51
Market value			6, 659, 871. 51		
Difference			2, 876, 898. 17		

This discrepancy becomes more significant in view of the following resolution of the executive committee adopted on December 2, 1929 (Public Examination, Liberty Share Corporation, at 9037):

"Resolved, that this corporation inventory its securities, other than its holdings of Treasury Stock, as of December 31, 1929, and in subsequent years, on the basis of 'cost or market,' whichever is lower, and that statement of the corporation be issued to stockholders as soon after close of current year as is possible."

Mr. Gerner was unable to explain the discrepancy between the investments at cost on the books of $7,784,065.06 and $11,907,593.72 as published in the annual statement of 1930: [158]

Q. Why were you carrying this seven million dollars on your books and eleven million dollars in your public statement?

A. I don't know. I haven't any idea. That is something I can't answer.

On December 31, 1930, $4,191,297 was owed by insiders to the investment company. While the published report disclosed that $6,451,728.83 was the amount of accounts and notes receivable, it did not indicate from whom they were receivable.[159]

Although the report of December 31, 1930 was prepared by the management of the investment company and approved by all its officers,[160] a day or two after it was mailed to stockholders, counsel disapproved of its publication. Mr. Gerner testified that it was sent out "in error." To rectify that "error" a stockholders' meeting was called, which was attended by only 25 stockholders. At that special meeting held on March 20, 1931,[161] the par value of the Liberty Share Corporation stock was changed from $10 per share to a stated value of $2 per share, and reserves of $2,800,000 were set up from the surplus arising from this reduction of capital stock account. Mr. Gerner testified: [162]

Q. Let us look at this report of December 31, 1930. Do you remember that?

A. I do very well. I also remember the fact that a day or two after that report went out counsel called our attention to the fact that it should not have gone out. It went out in error. There was nothing to be done about it except call a meeting of stockholders, and at that meeting of stockholders it was explained to them forthwith that the capital structure was changed to give us a surplus which we immediately set up as a reserve of $2,800,000 against the Liberty Shares that had been accumulated.

* * * * * * *

Q. Who signed the statement?

A. I have already stated it was sent out in error.

Q. And when you found the error, you called a stockholders' meeting to correct it, but you didn't tell all your stockholders you had made an error, did you?

A. We didn't send out a special letter concerning it.

Q. And only 20 or 25 stockholders attended?

A. That is right.

Q. So that the other 4,500 may or may not have found out about it?

A. That is right.

* * * * * * *

Q. As to the rest of them, did you send them any notice of the incorrect statement that was made in your annual report?

A. No, we did not.

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[158] Op. cit. supra, note 155, at 9039.

[159] Id., at 8998.

[160] Id., at 9013 and 9036.

[161] Id., at 9033–4, 9039–40, and Commission's Exhibit No. 867.

[162] Id., at 9033–40.

5. DISCLOSURE OF MANAGEMENT FEES

Sixteen closed-end companies and 13 open-end companies of the group examined paid management fees. These fees, whether fixed in amount, or computed upon the basis of the total fund managed, or contingent upon the realization of profits, comprise a material item in any determination of the results of the manager's services. Yet, of these 16 closed-end companies, as many as six failed to disclose the amounts expended. These companies in their published reports grouped management fees with other items of expense, and as a result all items of expense incidental to operations were obscured. As for the 13 open-end companies, 11 consistently disclosed the item, one company disclosed it each year except 1931, and one trust revealed this expenditure beginning only as late as 1934.

6. DISCLOSURE OF SALARY PAYMENTS

A common item of expense, involving at times large amounts, was the disbursement for salaries. Yet, as many as 40 of the 56 closed-end companies examined [163] failed to segregate this item. Only three of the closed-end companies consistently disclosed salaries, eight others did so in later years, and five revealed the amount of salaries in some years and not in other years.

Among the open-end companies, eight of the 14 reviewed paid no salaries. Management fees were paid in lieu of the salary payments. Of the six remaining open-end trusts, only two published salary expense as a separate item, and one indicated compensation paid to trustees, but not that paid to others in the employ of the trust. Three open-end trusts made no disclosure of the amounts of salaries paid.

7. DISCLOSURE OF COMMISSIONS PAID TO BROKERS

Commissions paid by investment companies to brokers as compensation for executing orders for purchases and sales of securities were not segregated as a memorandum on the books or on the statements prepared from the book accounts. Generally, commissions paid to brokers for purchases were recorded on the books as part of the cost of the securities acquired, and sales proceeds were recorded net after deducting sales commissions. Up to December 1935, none of the 60 closed-end or the 14 open-end companies under review disclosed in reports to shareholders the amounts paid as brokers' commission. The omission is more significant in the case of companies controlled or managed by brokers receiving the commissions.

8. DISCLOSURE OF LIQUIDATING VALUE PER SHARE

The closed-end companies, during their history, have been slow to furnish to stockholders the liquidating or net asset value per share of each class of outstanding stock (Table 65). Although the net asset value generally may be computed on the basis of the information contained in the balance sheet, the difficulty of this task varies with the simplicity or complexity of the company's capital structure.

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[163] Four of the 60 companies paid no salaries.

Stockholders may lack the experience and ability to make the necessary calculations.

TABLE 65.—*Disclosure of liquidating value per share in annual reports of 74 investment companies, 1927–35*

	Year of change	Number of companies
Closed-end companies:		
Disclosed consistently		23
Disclosed in later years	1929	3
	1931	3
	1932	5
	1933	3
	1934	2
	1935	3
		19
Disclosed in some years and not in others		6
Not disclosed consistently		12
Total		60
Open-end companies:		
Disclosed consistently		8
Disclosed in later years (after 1931)		2
Not disclosed consistently		4
Total		14

9. INCLUSION OF ACCOUNTANTS' CERTIFICATES

As at the end of 1935, the statements in the annual reports of 58 of the 60 closed-end and of all of the 14 open-end companies under examination were accompanied by accountants' certificates (Table 66).

TABLE 66.—*Inclusion of accountants' certificates in annual reports of 74 investment companies, 1927–35*

	Year of change	Number of companies
Closed-end companies:		
Included consistently		43
Included in later years	1928	1
	1929	3
	1930	2
	1931	3
	1932	1
	1934	2
	1935	1
		13
Included except for certain years		2
Not included consistently		2
Total		60
Open-end companies:		
Included consistently		13
Included in later years (after 1930)		1
Total		14

Of the two closed-end companies which in 1935 presented statements without accountants' certificates, the accounts of one company were not audited by public accountants.

E. Accountants' Certificates

A study was made of accountants' certificates which accompanied financial and operating statements included in published reports issued by closed-end and open-end companies.

The accounting profession has presented its views with respect to accountants' certificates mainly through three bulletins published by the American Institute of Accountants, entitled "Audits of Corporate Accounts" (January 1934), "Examination of Financial Statements by Independent Public Accountants" (January 1936), and "Extensions of Auditing Procedure" (October 1939). The standard form of accountant's certificate recommended by the Institute was first developed in collaboration with the New York Stock Exchange for adoption in connection with the examination of accounts beginning 1933. In 1939 this form was revised (the Institute's bulletin of October 1939). A standard form of accountant's certificate to guide the profession was therefore in existence during only 1934 and 1935 of the period studied.

The function of the independent public accountant, and his duties and responsibilities as compared to the responsibilities of the management with respect to accounting, are described in the Institute's bulletin of October 1939 as follows:

> In the performance of his duties as auditor, the independent certified public accountant holds himself out as one who is proficient in accounting practice and auditing procedure. The function of the independent certified public accountant is to examine a concern's accounting records and supporting data, in certain matters to obtain outside confirmations, and to require and consider supplementary explanations and information from the management and employees, to the extent necessary to enable him to form an opinion as to whether or not the financial statements as submitted present fairly the position and the results of periodic operations. Generally speaking, his function is limited to reporting upon situations arising out of business transactions that have taken place in the past. In no sense is he an insurer or guarantor. In offering his opinion, the independent certified public accountant assumes heavy responsibilities. He must be skilled in his professional work and must have made a reasonable examination of the accounts in order to warrant his expression of an opinion. He must state his opinion clearly and unequivocably.
>
> Management itself has the direct responsibility for the maintenance of an adequate and effective system of accounts, for the proper recording of transactions in the books of account, and for the safeguarding of the assets of a concern. It is also charged with the primary responsibility to stockholders and to creditors for the substantial accuracy and adequacy of statements of position and operations.

The accountant's certificate serves as the medium for the expression of his opinion whether the "financial statements as submitted present fairly the position and the results of periodic operations."

In this regard, the 1939 publication of the American Institute of Accountants stated:

The services which independent auditors render usually culminate in a report, which may take varying forms. In some cases a detailed report is rendered, accompanied by statements and supporting schedules; in other cases the report is limited to a concise statement of the scope of the examination and the related opinion of the independent auditor concerning the accompanying financial statements of the client. For present purposes the discussion is confined to the short form of auditor's report, which is sometimes described as a certificate. The terms "report," "opinion," "report and opinion," and "certificate" have been used interchangeably. As uniformity is desirable, either of the words "report" or "opinion" is recommended for general use. The word "report" has been adopted in the following comments.

In January, 1934, the Institute issued a pamphlet entitled "Audits of Corporate Accounts," dealing with a standard form of auditor's report. The short form of report then recommended, and since widely adopted by the profession, met a long-felt need.

Developments during the five years in which the standard form of report has been used indicate the need of revision in the interest of clarity. The revised short form of report consists of two paragraphs. The first contains a brief statement of the scope of the examination, and the second deals with the auditor's opinion on the financial statements of the client as a result of his examination.

In the 1939 pamphlet the Institute set forth the requisites of the accountant's certificate (the auditor's report) as follows:

It should be borne in mind that the financial statements, with all supplemental descriptive and explanatory data, including footnotes, are regarded as representations of the client. It is upon all these representations that the independent certified public accountant renders his opinion. If he considers explanations essential or desirable, and they have not been made in the financial statements, it will be necessary for him to make such explanations in a separate paragraph of his report.

In explanation of the general principles governing the auditor's opinion, with particular regard to explanations and exceptions, it is pertinent to state that the auditor satisfies himself as to the fairness of the statements "by methods and to the extent he deems appropriate," in general conformity with the auditing procedures recommended in the Institute's bulletin *Examination of Financial Statements*. Ordinarily, if he has so satisfied himself, he is in a position to express an unqualified opinion. However, if he considers it in the interest of clear disclosure of material fact to include explanations of procedures followed, he is free to do so. If, on the other hand, such disclosures are made by reason of any reservation or desire to qualify the opinion, they become exceptions and should be expressly stated as such in the opinion paragraph of the auditor's report. As previously stated, if such exceptions are sufficiently material to negative the expression of an opinion, the auditor should refrain from giving any opinion at all, although he may render an informative report in which he states that the limitations or exceptions relating to the examination are such as to make it impossible for him to express an opinion as to the fairness of the financial statements as a whole.

It is desirable as a general rule that exceptions by the independent certified public accountant be included in a paragraph separate from all others in the

report and be referred to specifically in the final paragraph in which the opinion is stated. Any exception should be expressed clearly and unequivocally as to whether it affects the scope of the work, any particular item of the financial statements, the soundness of the company's procedures (as regards either the books or the financial statements), or the consistency of accounting practices where lack of consistency calls for exception.

Expressions in the same vein were included in the earlier publication of the American Institute of Accountants in 1936.[164]

The Commission's requirements with respect to accountants' certificates and independence of accountants are contained in Regulation S–X as follows:[165]

CERTIFICATION BY ACCOUNTANTS.

(a) The accountants' certificate (1) shall be dated; (2) shall be signed manually; (3) shall identify without detailed enumeration the financial statements certified; (4) shall contain a reasonably comprehensive statement as to the scope of the audit made; (5) shall state whether there have been any changes in accounting principles or practices required to be set forth by rule 3.07 and shall state clearly the accountants' opinion as to any such changes; and (6) shall state clearly the opinion of the accountants in respect of the

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[164] While the above are principles recently expressed by the American Institute of Accountants with regard to accountants' certificates, an early expression by a member of the profession, Robert H. Montgomery, was as follows in his text *Auditing Theory and Practice* (1934), pp. 696–7:

"Function and Importance of the Certificate

"The Certificate is a formal concise report by the auditor. It usually expresses his opinion regarding the statements to which it relates. It is appended to published financial statements or to those furnished to shareholders or creditors who do not have access to the auditor's detailed comments in his report. Even though the auditor may have assisted the management in formulating and preparing them, the financial statements are to be considered accounting reports prepared and presented by the management and his function as auditor is to express his professional opinion regarding them. The certificate, therefore, is normally the only statement of the auditor which is published. It is of paramount importance in its bearing on his professional standing and obligations.

"Auditors work meticulously over the drafting of their certificates so that they may express to the careful reader the precise meaning intended to be conveyed. Because the certificate is concise and yet may bear on financial undertakings of magnitude, it must be free from possibilities of wrong inferences and over- or under-emphasis in the language used. A certificate should never be ambiguous. Any doubt in the mind of the reader reflects adversely on the auditor. It must carry conviction; otherwise the auditor should not append a certificate to the balance sheet.

"The casual reader of the certificate, too, must be reckoned with. The reputable auditor, therefore, will render no certificate which creates a misleading general impression even if accurate in studied detail. He should not be content to limit himself to his legal responsibility alone."

[165] Regulation S–X became effective February 21, 1940, but the requirements as set forth above were in the main previously incorporated in the Instruction Book for Form 10–K, December 16, 1935, and in Accounting Series, Release No. 2, dated May 6, 1937. In Accounting Series Release No. 12, issued in connection with the promulgation of Regulation S–X, the Commission stated:

"In view of the pending proceedings in the matter of McKesson and Robbins, Incorporated, and several other cases, the rules governing certification by accountants, although altered and clarified in some respects, have been retained in substantially the form now found in the General Rules and Regulations under the Securities Act of 1933 and the several major forms under the 1933 and 1934 Acts. Upon completion of these proceedings, however, such rules are to be reconsidered with a view to revisions deemed necessary as a result of these cases." *In this connection see Rule 2–02 of Regulations S–X, effective March 1, 1941, substantially revising the Commission's requirements with respect to accountants' certificates.*

financial statements of, and the accounting principles and procedures followed by, the registrant and its subsidiaries.

(b) In certifying the financial statements, the accountants may give due weight to an internal system of audit regularly maintained by means of auditors employed on the registrant's own staff. The accountants shall review the accounting procedures followed by the person or persons whose statements are certified and by appropriate measures shall satisfy themselves that such accounting procedures are in fact being followed. Nothing in these instructions shall be construed to imply authority for the omission of any procedure which independent accountants would ordinarily employ in the course of an audit made for the purpose of presenting comprehensive and dependable financial statements.

(c) Any matters to which the accountants take exception shall be clearly identified and the exception thereto specifically and clearly stated.

(d) If certification is made by an individual accountant, the above provisions as to accountants shall be read in the singular.

* * * * * * *

CHANGES IN ACCOUNTING PRINCIPLES AND PRACTICES.

If any significant change in accounting principle or practice has been made at the beginning of or during any period covered by the profit and loss statements filed, a statement as to the change shall be given in a note to the appropriate statement, and if the change substantially affects proper comparison with the preceding fiscal period, the necessary explanation.

* * * * * * *

QUALIFICATIONS OF ACCOUNTANTS.

* * * * * * *

(b) The Commission will not recognize any certified public accountant or public accountant as independent who is not in fact independent. An accountant will not be considered independent with respect to any person in whom he has any substantial interest, direct or indirect, or with whom he is, or was during the period of report, connected as a promoter, underwriter, voting trustee, director, officer, or employee.

The standard form of accountant's certificate which was adopted for accounts examined beginning with the year end 1933, and which was in effect during the period under review for the two years 1934 and 1935, is reproduced below accompanied by six notes submitted by the American Institute of Accountants as explanatory aid, viz: [166]

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[166] The standard form as revised in 1939, is as follows:

"SHORT FORM OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANT'S REPORT OR OPINION

"*To the Board of Directors (or Stockholders) of the XYZ Company:*

"We have examined the balance-sheet of the XYZ Company as of April 30, 1939, and the statements of income and surplus for the fiscal year then ended, have reviewed the system of internal control and the accounting procedures of the company and, without making a detailed audit of the transactions, have examined or tested accounting records of the company and other supporting evidence, by methods and to the extent we deemed appropriate.

"In our opinion, the accompanying balance-sheet and related statements of income and surplus present fairly the position of the XYZ Company at April 30, 1939, and the results of its operations for the fiscal year, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

"It is worthy of repetition and emphasis that, while the proposed form is submitted as a standard, it is not prescribed or recommended for invariable use, but should be adapted to the needs of the particular case."

(*Modification of this form has been made necessary by the Commission's revised Rule 2–02 of Regulation S–X effective March 1, 1941, for which see statements on Auditing Procedure, No. 5 and No. 6, issued by American Institute of Accountants.*)

To the X Y Z Company:

We have made an examination of the balance sheet of the X Y Z Company as at December 31, 1933, and of the statement of income and surplus for the year 1933. In connection therewith, we examined or tested accounting records of the company and other supporting evidence and obtained information and explanations from officers and employees of the company; we also made a general review of the accounting methods and of the operating and income accounts for the year, but we did not make a detailed audit of the transactions.

In our opinion, based upon such examination, the accompanying balance sheet and related statement of income and surplus fairly present, in accordance with accepted principles of accounting consistently maintained by the company during the year under review, its position at December 31, 1933, and the results of its operations for the year.

NOTES

1. It is contemplated that, before signing a report of the type suggested, the accountant should have at least made an examination of the character outlined in the bulletin, *Verification of Financial Statements*, as interpreted in the communication of the committee on stock list to the governing committee dated October 24, 1933.

2. The report should be addressed to the directors of the company or to the stockholders, if the appointment is made by them.

3. The statement of what has been examined would, of course, conform to the titles of the accounts or statements reported upon.

4. In the second sentence, any special forms of confirmation could be mentioned: e. g., "including confirmation of cash and securities by inspection or certificates from depositories."

5. This certificate is appropriate only if the accounting for the year is consistent in basis with that for the preceding year. If there has been any material change either in accounting principles or in the manner of their application, the nature of the change should be indicated.

6. It is contemplated that the form of the report would be modified when and as necessary to embody any qualifications, reservations, or supplementary explanations.

The condition which existed prior to the adoption, at the beginning of 1934, of the standard form, is described in an editorial in the April 1937 "Journal of Accountancy," the official organ of the American Institute of Accountants, as follows:

Four years ago auditors' reports and certificates in this country varied to a considerable extent both in form and substance. There was lack of general appreciation as to just what the auditor had done. Qualifications and reservations were phrased in different ways and many readers were uncertain as to whether the statements had been certified without qualification or not.

In 1934 a committee of the American Institute of Accountants suggested a form of auditor's report which received the approval of the New York Stock Exchange. * * * Within the short space of three years, this form of auditor's report has been incorporated in substance in the annual reports to stockholders of more than 95 percent of the corporations listed on the "big board" (exclusive of railroads).

Although the "Journal of Accountancy" commented on the subsequent improvement of the unsatisfactory conditions which existed prior to 1934, the study revealed that all abuses and deficiencies had

not been eliminated. In May 1938 the Securities and Exchange Commission issued a release citing the deficiencies commonly prevailing in accountants' certificates appended to financial statements filed pursuant to the Securities Act of 1933 and the Securities Exchange Act of 1934.[167] The deficiencies listed were similar to those found to exist in certificates accompanying the statements of the investment trusts and companies reviewed. These deficiencies may be summarized as follows:

1. Use of equivocal phrases such as "on the basis indicated," "subject to the foregoing," "subject to the above comments," "subject to comments and explanations in exhibits," "subject to the accompanying comments," etc.

2. Effect upon the financial statements of substantial changes in accounting policies of the company not commented upon and explained by the certifying accountants.

3. Effect upon the financial statements of the company's failure to follow generally accepted accounting principles and procedures not commented upon and explained by the certifying accountants.

4. Certifying that the accounting principles followed by the company are in accordance with the company's charter, but without indicating whether the practice is in accordance with generally accepted accounting principles and procedures.

5. Failure to include in the certificate a reasonably comprehensive statement as to scope of the audit made.

These deficiencies existed in the accountants' certificates contained in the annual reports published by the investment companies studied. A total of 420 certificates for the period 1927 to 1935 were analyzed.[168]

1. EQUIVOCAL QUALIFICATIONS

The equivocal qualification most widely used among these 420 certificates, particularly during the years 1930 to 1934, may be described as "on the basis indicated therein." Examples of certificates containing this type of vaguely restrictive or informative qualification, typical of others, were as follows:

1.

We have examined the accounts of Home and Foreign Securities Corporation as at June 30, 1930, and we certify that, in our opinion, on the basis therein stated, the foregoing balance sheet and income account correctly set forth the financial position of the corporation at June 30, 1930, and the results of its operations for the year then ended.

LYBRAND, ROSS BROS. & MONTGOMERY,
Accountants and Auditors.

NEW YORK, *July 17, 1930.*

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[167] Accounting Series, Release No. 7.

[168] There were a few companies among the 76 companies under review which omitted annual reports at intervals within this period or during their entire existence. The number of certificates under examination as divided by years follows:

Year:	*Number of certificates examined*	*Year:*	*Number of certificates examined*
1927	10	1932	56
1928	23	1933	61
1929	41	1934	66
1930	51	1935	55
1931	57	Total	420

2.

We have examined the books and accounts of Blue Ridge Corporation for the year ended December 31, 1930. We have counted or otherwise verified the securities owned on that date, and we certify that, in our opinion, the foregoing balance sheet and statements of income and surplus set forth the financial position of the Corporation as of December 31, 1930, and the result of the transactions for the period on the basis indicated therein.

PRICE, WATERHOUSE & CO.

56 PINE STREET, NEW YORK, *January 28, 1931.*

3.

We have examined the accounts of Bullock Fund, Ltd., as at December 31, 1934. The list of securities certified by the Guaranty Trust Company of New York as being in its custody at that date agrees with the records of the corporation. Upon the basis indicated therein, we certify that in our opinion, the accompanying balance sheet and income, distribution and surplus accounts set forth the financial position of the corporation at December 31, 1934, and the results of its operations for the year then ended.

LYBRAND, ROSS BROS. & MONTGOMERY.

NEW YORK, *January 23, 1935.*

It is difficult to ascertain whether this phrase "on the basis indicated therein" is intended as a qualification by the certifying accountants. If a dissent, exception or reservation is intended, the language should be clear, unequivocal and patent.

The expression "on the basis indicated therein" apparently was first used in investment companies in the 1929 certificates. From 1929 to 1935, for which period 387 certificates were examined, 143 contained this form of ambiguous qualification (Table 67).

TABLE 67.—*Number of accountants' certificates in reports of investment companies containing clause "on the basis indicated therein," 1929–35*

Year	Total number of certificates under review	Certificates containing clause "on the basis indicated therein"
1929	41	7
1930	51	15
1931	57	27
1932	56	27
1933	61	26
1934	66	26
1935	55	15
	387	143

The certificates below, by comparison, reveal the indefiniteness of those other certificates which contain the phrase "on the basis indicated therein" without specifying the basis:

1.

Pacific Southern Investors, Inc. We have audited your accounts for the year 1933. The securities owned were verified by confirmation from the Chase National Bank of the City of New York, or by examination, and the cash balance was confirmed by certification of the depositories. The investment securities are stated at cost on the "first-in, first-out" method, and on this basis, in our opinion, the above balance sheet and accompanying statement of income set forth, respectively, your financial condition at December 31, 1933, and the results of your operations for the year ended that date.

HASKINS & SELLS.

LOS ANGELES, *January 15, 1934.*

2.

We have examined the accounts of Railway and Light Securities Company for the year ended December 31, 1932, and have accounted for the securities owned by the company at that date.

We certify that in our opinion the accompanying Balance Sheet as at December 31, 1932, and Statements of Income, Earned Surplus and Special Surplus set forth the financial position of the Company at December 31, 1932, and the results of its operations for the year ended, on the basis of carrying at adjusted values securities acquired subsequently.

We further certify that, in our opinion, the investments of the company as at December 31, 1932, are correctly stated in the appended list of securities owned.

LYBRAND, ROSS BROS. & MONTGOMERY.

BOSTON, MASSACHUSETTS, *January 26, 1933.*

2. NONDISCLOSURE OF CHANGES IN ACCOUNTING PRACTICES

A serious handicap to the investors in the investment companies reviewed was the complete absence in the accountants' certificates of information revealing the changes in accounting principles and practices as they occurred, especially as they affected an accurate comparison with the preceding fiscal periods. Of the 420 certificates examined, only one certificate commented on a change in practice and set forth the amounts of differences involved in the change.[169] This situation existed even though frequent changes in accounting practices occurred, particularly with respect to bases of computing of profits and losses upon the sales of securities.

For example, American Superpower Corporation had followed the practice from 1927 to and including 1933 of reflecting in published accounts profits and losses on sales of securities in income account, and in 1934, of showing security losses as a deduction from net ordinary income. In 1935 this procedure was changed and such losses were carried to reserve account. However, the certificate did not disclose this change:

CERTIFICATE OF AUDITORS

We have examined the accounts and records of The American Superpower Corporation for the year ended December 31, 1935. Securities, including Stock

[169] See infra, pp. 2084–86.

transferred to the Bankers Trust Company, and Cash were confirmed by certificates received from Custodians and Depositories, respectively. We hereby certify that, in our opinion, the above Balance Sheet, and the related statements of Income and Earned Surplus, Capital Surplus, and Reserve for Decrease in Market Value of Securities reflect the true financial condition of the Corporation as at December 31, 1935, and the results of operations for the year ended on that date.

R. G. Rankin & Co.,
Certified Public Accountants.

3. FAILURE TO SPECIFY THAT ACCOUNTING PRACTICE USED WAS NOT GENERALLY FOLLOWED

In some instances the accountants disclosed in the certificates that a particular accounting practice was followed, but failed to specify, when applicable, that the practice was not in accordance with accounting principles generally followed. In addition, in those instances, the effect upon the financial statement of the company's failure to follow the generally accepted practice, was omitted. The omission to specify that the practice was not one generally followed, is illustrated by the certificate by Lybrand, Ross Bros. & Montgomery which accompanied the annual report of Dividend Shares, Inc., for the year ended December 31, 1935:

The entire net cash proceeds received from the sales of stock dividends and rights were included in income; those items may not be true income but the practice is in pursuance of the provisions of the corporation's certificate of incorporation.

This certificate may be compared with the certificate dated July 20, 1936, furnished with the financial statement filed with the Commission in connection with the registration of the securities of the company, which contained the specification that the treatment commented upon is not in accordance with the accounting practice generally followed:

The entire net cash proceeds received from the sales of regular stock dividends and rights were included in income; those items may not be true income, but the practice is in pursuance of the provision of the corporation's certificate of incorporation.

Pursuant to a resolution of the Board of Directors, dividends declared are first charged against the net amount of capital surplus credited to distribution account, instead of first against earned income.

The treatment of regular stock dividends and rights sold and dividends paid by the corporation as set forth in the two preceding paragraphs is not in accordance with the accounting practice generally followed with respect to such items. However, in view of the provisions in its certificate of incorporation, the accounting treatment followed by the corporation, in our opinion, appears acceptable under these circumstances.

4. EXPRESSIONS CONTAINED IN CERTIFICATES DENOTING DISSENTS OR EXCEPTIONS AND EXPRESSIONS OF AN INFORMATIVE NATURE

In addition to 143 certificates which contained the clause "on the basis indicated," or a similarly worded clause, only an exceedingly

small number of the 420 certificates examined were qualified in the sense that the accountants took exception or dissented to any of the accounting practices of the company. During the earlier period 1927 to 1931, such qualifications were rare, but beginning in 1932 the practice of so qualifying certificates became more general. (See Table 68.)

TABLE 68.—*Significantly restrictive and informative expressions contained in certificates, 1927–35*

Year ended in—	Informative expressions included	Informative expressions not included	Year ended in—	Informative expressions included	Informative expressions not included
1927	1	9	1933	12	49
1928	2	21	1934	11	55
1929	3	38	1935	13	42
1930	3	48			
1931	3	54	Total certificates	54	366
1932	6	50			

Examples of the forms of these exceptions, dissents and reservations follow.

a. Certificates Taking Exception to Accounting Practices Which Were Authorized by Charter Provisions or by Income Tax Rulings

The form of qualification which not only contained a clear statement of the accountant's exceptions to the company's accounting practice, but also included a concise discussion indicating wherein the said practice was not in accordance with generally accepted principles, was rare. The accountants for only one company, Quarterly Income Shares, Inc., in their reports for the fiscal years ended October 15, 1933, and October 15, 1934, followed this procedure.

CERTIFICATE

QUARTERLY INCOME SHARES, INC.:

We have examined your accounts for the period from the date of incorporation, December 9, 1932 to October 15, 1933, your balance sheet of October 15, 1933, and your statement of income and distribution for the period stated, and funds appropriated for distribution November 1, 1933, both of which statements, as prepared by you, are appended hereto.

We have made appropriate and comprehensive tests of your transactions during the period.

In computing profits and losses from sales of securities, as shown in the accompanying balance sheet, the company has employed as a cost basis (as set forth in its statements) the identified cost of the actual certificates sold. Such method, which has been approved for many years by the United States Treasury Department for Federal Income Tax purposes, permits the company, when sales are made, to identify as the shares sold those determined by the selection of the lowest cost certificate or the highest cost certificate, or any certificate having a cost between the two, as it may elect. In our opinion, the average cost method or the "first-in, first-out" method of determining costs for computation of profit is preferable from an accounting viewpoint to the method used by the company because the effect of the company's method may be less equable with respect to

profits and losses and remaining asset costs than the other two methods. The management, however, maintains that in its business the identification method is preferable, as it permits through the selection of low cost certificates the sale of a lesser number of shares to accrue the same amount of realized profit than would be the case under either of the other methods and, therefore, permits a saving on transfer stamp taxes and on selling and buying commissions.

Under the terms of its Certificate of Incorporation and in accordance with a Federal Income Tax ruling by the Treasury Department in a similar case, the company has credited to distribution account $169,111.15 representing trust share accumulations of dividends and interest accumulated principally prior to purchase of the trust shares. In our opinion, had credits to the distribution account been made in accordance with a well-recognized conception of income instead of in accordance with the Certificate of Incorporation and the Treasury Department ruling, this amount would not have been credited to the distribution account but would have been credited approximately $100,198.36 to cost of securities owned at October 15, 1933, and approximately $68,912.79 to profit from sales of securities for the period from December 9, 1932, to October 15, 1933.

In computing the amount ($138,344.11) of the distribution for the period from the date of incorporation to April 15, 1933, the company, in accordance with its Certificate of Incorporation, did not deduct from the distribution account a net loss of $41,852.29 from sales of securities up to that date, but in computing the amount of the distribution account at July 15, 1933, at which date there existed a net profit (before provision for Federal income tax) of $315,926.46 from sales of securities (after deduction of the net loss of $41,852.29 referred to above) for the period from the date of incorporation to July 15, 1933, and in computing the amount of the distribution account at October 15, 1933, at which date there was a balance of net profits (before provision for Federal income tax) from sales of securities amounting to $183,975.44, the company included a portion of such net profits amounting to $52,205.14 and $75,000.00, respectively, in the distribution accounts as of those dates, under the provisions of the Certificate of Incorporation that the Board of Directors may distribute such profits. Had the net losses as existing at April 15, 1933, been deducted from the distribution account at that date and had the related distribution of May 1, 1933, been correspondingly reduced, the balance sheet of October 15, 1933, would have shown cash balances and net profits from sales of securities $41,852.29 in excess of the amounts shown in the accompanying balance sheet.

Consistent accounting practice would require the same treatment for security losses as for security profits, namely, either the exclusion of both from or the inclusion of both in the distribution account. The counsel of the company informs us however that the Certificate of Incorporation does not permit the deduction of realized losses from net cash income but that the latter is required to be distributed to shareholders. The management further maintains that the policy followed is advantageous, pointing out that the provisions of the Certificate of Incorporation were formulated on the basis of assuring to stockholders, so far as possible, distributions of cash income, without taking into account losses on sales of securities due to shrinkage in market quotations, as if the stockholders were the owners of the securities owned by the company. The management also points out that the company has at no time paid distributions when the market value of securities owned after deducting losses realized was not equal to or greater than their cost.

In our opinion, subject to the foregoing, the said balance sheet and statement of income and distribution, together with the explanations and notations thereon,

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set forth respectively, your financial condition as of October 15, 1933, and the results of your operations for the period from the date of incorporation, December 9, 1932 to October 15, 1933.

HASKINS & SELLS,
Certified Public Accountants.

NEW YORK, *October 26, 1933.*

ACCOUNTANTS' REPORT

QUARTERLY INCOME SHARES, INC.

We have made an examination of the balance sheet of Quarterly Income Shares, Inc., as at October 15, 1934, with a schedule pertaining to holdings, and of the statement of distribution account, the statement of income, the statement of unappropriated net profit from sales of securities, and the statement of paid-in and capital surplus, for the year ended October 15, 1934. In connection therewith, we examined or tested the accounting records of the corporation and other supporting evidence for the period from January 16 to October 15, 1934, and we were furnished with the reports of other accountants for the period from October 16, 1933, to January 15, 1934.

The Corporation has determined its net profit from sales of securities by identifying the cost of the certificates delivered, in accordance with its established practice, which practice is approved by the United States Treasury Department for Federal income tax purposes. In our opinion, the determination of profits and losses from sales of securities on the basis of the average-cost of the securities owned (which basis would have resulted in realized profits and the cost of investments owned at October 15, 1934, being stated at approximately $537,000.00 less on the accompanying balance sheet, and net profits from sales of securities for the year being stated at approximately $484,000.00 less on the accompanying statement) is preferable from an accounting viewpoint, although such method is not approved by the Treasury Department for Federal income tax purposes. The aggregate of the realized and unrealized profits and losses since date of incorporation would be the same under either method.

Under the terms of its Certificate of Incorporation and in accordance with a Treasury Department ruling in a similar case, the corporation has included in its distribution account since date of incorporation trust share accumulations in respect of cash dividends and interest which accrued, principally, prior to the purchase of the trust shares; with the result that the cost of investments at October 15, 1934, is approximately $203,000.00 greater as stated on the accompanying balance sheet, than if such accumulations had been applied as a reduction of the cost of investments. The net asset value of the stock of the corporation, after giving effect to the value of investments at closing market quotations, however, is not affected thereby.

In our opinion, subject to the foregoing, the accompanying statements (as described above) together with the explanations and notations thereon, fairly present, in accordance with accepted principles of accounting, consistently followed by the corporation, its financial condition at October 15, 1934, and the results of its operations for the year ended that date.

PRANKARD & ZIMMERMANN,
Certified Public Accountants.

NEW YORK, *October 20, 1934.*

The certificate of another company qualified by implication a certain accounting practice—a practice which was in accordance with its charter provisions. This certificate, however, did not contain any

indication of the difference between the company's practice and that generally accepted:[170]

* * * The entire net cash proceeds received from the sales of stock dividends and rights were included in income; those items may not be true income but the practice is in pursuance of the provisions of the corporation's certificate of incorporation * * *

In another company, the same firm of accountants, commenting with reference to an accounting practice followed in accordance with the company's declaration of trust, did not contain any implication of dissent:[171]

* * * The accompanying statement of income and expense includes in income the indicated amounts of proceeds from sales of stocks received as stock dividends which[172] may be included as earnings under Article VIII of the Declaration of Trust * * *

b. Certificates Qualified by Reference to Contingent Liabilities

Only two instances of contingent liabilities were stated in the certificates reviewed. The contingent liability shown in one certificate (1928) was not revealed elsewhere in the report to the stockholders while with respect to the other certificate (1935) the contingent liability was shown also as a footnote to the balance sheet.

* * * At December 31, 1928 the Company had contingent liabilities (not exceeding $500,000.00) on commitments in respect of participation in open syndicates, which are expected to result in a profit to the Company * * *[173]

* * * No provision has been made for any possible liability for Federal Income Tax on the "special dividend" received during the year from Allied Shares Corporation concerning which a ruling has been requested from the Bureau of Internal Revenue * * *[174]

c. Qualifications That the Financial Position was Subject to Deduction or was Without Provision for Unrealized Depreciation of Portfolio Securities

The qualification, which put the investor on notice that allowances for unrealized depreciation of portfolio securities must be made in appraising the financial condition of the company, was not as common as it might have been, although many investment companies either effected write-downs of investments, created portfolio reserves, or carried portfolios at the lower of cost or market (methods which one way or another provided for all or some part of the depreciation of portfolio securities), as the review hereinbefore revealed. The cer-

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[170] Lybrand, Ross Bros. & Montgomery, report to Dividend Shares, Inc. for the year ended December 31, 1935.

[171] Lybrand, Ross Bros. & Montgomery, reports to Massachusetts Investors Trust for the years ended December 31, 1934 and 1935.

[172] The certificate in the 1934 report contained, at the point indicated, the additional clause "according to opinion of legal counsel of the trust."

[173] Price, Waterhouse & Co., report to General American Investors Co., Inc. for year ended December 31, 1928.

[174] Price, Waterhouse & Co., report to Phoenix Securities Corporation for fiscal year ended August 31, 1935.

tificates of only five companies contained these qualifications. In four of these five instances the amount of the unrealized depreciation was revealed or was calculable from the facts and amounts shown elsewhere in the report. Therefore these qualifications served as an additional reminder that the financial condition reflected in the balance sheet did not take into consideration the fact that the market value of the portfolio was below that shown under assets in the report.

The certificates containing the qualification under discussion follow:

> * * * subject to the fact that the investments are shown at a value exceeding the market value by an amount not stated, but less than the balance in surplus * * * [175]

> * * * this income statement includes no adjustment with reference to current market value of securities * * *.[176]

> * * * subject to the deduction of the indicated decline in the values of the investments * * *.[177]

> * * * subject to the indicated shrinkage in investment valuations below the amount at which investments are carried * * *.[178]

> * * * No provision has been made from income or surplus for the excess of the cost of securities over their values at market quotations and for values as appraised by the directors * * *.[179]

> * * * No provision has been made in the accounts for unrealized depreciation of securities at February 28, 1934 * * *.[180]

> * * * The investments are carried at cost or company's valuation, which at December 31 was $ in excess of market values (partially estimated) * * *.[181]

d. Certificates Containing Qualification That the Valuations Were Those Established by the Company

In those instances where investments were carried at an unusual basis of valuation, such as a valuation established by the company, the certificates contained an appropriate qualification.

> * * * based upon valuation of investments at cost or at company's valuations.[182]

> * * * The investments are carried at cost or at company's valuation * * *.[183]

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[175] Price, Waterhouse & Co., report to The Investment Company of America, for the year ended December 31, 1929.

[176] Price, Waterhouse & Co., report to The Investment Company of America, for the year ended December 31, 1930.

[177] Lybrand, Ross Bros. & Montgomery, reports to The Reybarn Company, Inc., for the fiscal years ended May 31, 1932 and 1933.

[178] Lybrand, Ross Bros. & Montgomery, report to the Reybarn Company, Inc., for the fiscal year ended May 31, 1934.

[179] Haskins & Sells, reports to Reynolds Investing Company, for the years ended December 31, 1933 and 1934.

[180] Beard & Abney report to British Type Investors, Inc., for the fiscal year ended February 28, 1934.

[181] Haskins & Sells, reports to Eastern States Power Corporation, for the years ended December 31, 1933, 1934, and 1935

[182] Haskins & Sells, reports to Eastern States Power Corporation, for the years ended December 31, 1930, 1931, and 1932.

[183] Haskins & Sells, reports to Eastern States Power Corporation, for the years ended December 31, 1933, 1934, and 1935.

* * * Valuations thereof have been made at December 31 [1931 and 1932], and we have verified such of them as represent market quotations; the remainder represent appraisals made by the directors of the company. * * *[184]

* * * The total cost of securities, as carried in the balance sheet, shows an excess of [1933, $8,969,189.05; 1934, $7,553,825.01] over the total value thereof as appraised by the directors. * * *[185]

* * * The investment securities acquired for stock on January 2, 1926, are carried on the books at the approximate market value at that date, as determined by the Board of Directors. Those acquired subsequently are carried at cost.[186]

The certificates which follow indicate other subjects which were matters for qualification by the accountants for the companies under review.

e. Certificate Limiting Financial Condition to Basis of Valuation of Certain Securities at Their Book Values

* * * The investments in shares of capital stocks of 18 Banks, whose accounts were not examined by us (majorities of whose shares are owned by the Trustees) are stated in the attached Balance Sheet at the book value of the shares of said 18 Banks, as shown by their Statements of Condition as at [date] certified by officers of the Banks.[187]

f. Certificate Limiting Financial Condition to Basis of Valuation of Security of Subsidiary Company

* * * subject to the valuation of the investment in United States & International Securities Corporation * * *.[188]

g. Certificates which Certified Balance Sheets after Stating Acceptance of Basis of Valuation of Stock Dividends

* * * accepting the basis of valuation of stock dividends * * *.[189]

h. Certificate Qualified for Treasury Stock Carried as an Asset at Market Value

* * * subject to 17,383 shares of preferred stock of the company being carried as an asset at market value, pending its disposition.[190]

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[184] Haskins & Sells, reports to Reynolds Investing Company, Inc., for the years ended December 31, 1931 and 1932.

[185] Haskins & Sells, reports to Reynolds Investing Company, Inc., for the years ended December 31, 1933 and 1934.

[186] Niles & Niles, reports to American European Securities Company, for the years ended December 31, 1927, 1928, and 1929.

[187] Peat, Warwick, Mitchell & Co., reports to Old Colony Trust Associates, for the years ended December 31, 1933, 1934, and 1935.

[188] Price, Waterhouse & Co., report to United States & Foreign Securities Corporation, for the year ended December 31, 1930.

[189] Touche, Niven & Co., report to American Cities Power & Light Corporation, for the years ended December 31, 1933 and 1934; report to Electric Shareholdings Corporation, for the year ended December 31, 1933; reports to Central States Electric Corporation for the years ended December 31, 1933 and 1934.

[190] Arthur Andersen and Company, report to Second National Investors Corporation, for the year ended December 31, 1933.

i. Certificate Qualified on Account of Inclusion of Stock Dividends in Income

* * * subject to the inclusion of stock dividends as income * * *.[191]

j. Certificate Qualified on Account of Computation of Profits and Losses on Basis of Replacement Cost

* * * In the case of securities sold and repurchased prior to the end of the year, profit & loss has been generally computed on the basis of replacement cost only. * * *[192]

The excerpts of certificates already reproduced expressed reservations, exceptions, or dissents. While the excerpts which follow deal with comments of an informative nature, it can be said as to some of them that they are also expressions which are qualifications in character. These excerpts contain information such as references to changes in accounting practices, treatment of write-downs of investments, and profits and losses upon the sale of securities subsequent to write-downs. The accounting treatment referred to in some of these certificates is that generally accepted. In others, exceptions were taken to the accounting treatment followed, but the reasons for the dissent were not indicated.

One certificate, as will be presented, indicated the company's established accounting policy, but the accountants expressed neither approval nor disapproval of the accounting procedure followed.

k. Changes in Accounting Practices

* * * in accordance with accepted principles of accounting which have been maintained (consistently except as explained in notes regarding consolidated statements) * * *.

Notes regarding Consolidated Statements.

* * * * * * *

Income for the year 1935 includes dividends receivable in 1936 on stocks which sold ex-dividend on or before December 31, 1935. In prior years, dividends were taken up as income only when collected and as a result certain dividends collected in 1935 which would have been applicable under the newly adopted practice to income for the year 1934 have been included in dividend income for 1935. The aggregated amount of these dividends was $62,070.00.

Effective January 1, 1935, realized profits and losses on securities have been credited and debited to Capital Surplus, whereas previously such profits and losses were credited and debited to Earned Surplus.[193]

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[191] Lybrand, Ross Bros. & Montgomery, reports to Massachusetts Investors Trust for the years ended December 31, 1931, 1932 and 1933.

[192] Beard & Abney, reports to British Type Investors, Inc., for the fiscal years ended February 28, 1934 and 1935.

[193] Loomis, Suffern & Fernald, report to The Adams Express Company for the year ended December 31, 1935.

l. Credit Arising From Purchase of Corporation's Debentures Applied to Reduction of Unamortized Debenture Discount

* * * A credit of $442,817.75 arising from purchase of the corporation's debentures has been applied in reduction of unamortized debenture discount * * *.[194]

m. Statement That Market Value Was Not a Representation That This Value Was Realizable Upon Liquidation

* * * In calculating market values for securities, market quotations current with the balance sheet dates obtained from publications or other sources believed to be reliable have been applied to the number of shares of stock or par value of bonds held. This statement of market values is not intended as a representation or expression of opinion as to the actual amounts realizable upon a liquidation of the securities held at the balance sheet dates. * * *[195]

n. Collectibility of Demand Note Secured by Collateral

* * * With regard to the demand note of $899,920.18, we are informed that it is not expected that there will be any substantial recovery in excess of the value of the collateral security [$326,748] when sold. * * *[196]

o. Treatment of Write-Downs of Investments and Profits and Losses Upon the Sale of Investments Subsequent to Write-Downs

* * * By authority granted at a special meeting of the stockholders, the entire balance of operating surplus of $524,893.63 as at April 30, 1933, and $13,056,115.84 of capital surplus were applied in reduction of the book value of investments, and profits and losses on security transactions subsequent to such date accordingly are based on the adjusted book values then established and are set forth in the balance sheet under the caption of "Earned Surplus and Undistributed Profits." * * *[197]

* * * As of September 30, 1935, as disclosed in the statements, the directors adjusted, by a net write-down of $7,121,988.33, the book value of securities owned * * *; of the total net write-down a net amount of $6,627,125.09 was charged to capital surplus, and an amount of $494,863.24 was charged to earned surplus account exhausting the balance therein. The directors established a new earned surplus account from October 1, 1935, to which were carried operating and trading results for the last quarter of the year, including net profits from sales of securities, computed on the cost basis of the adjusted book values at September 30, 1935.[198]

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[194] Touche, Niven & Co., report to Central States Electric Corporation for the year ended December 31, 1933.

[195] Loomis, Suffern & Fernald, report to The Adams Express Company for the year ended December 31, 1935.

[196] Peat, Warwick, Mitchell & Company, report to Old Colony Trust Associates for the year ended December 31, 1932.

[197] Touche, Niven & Co., report to American Cities Power & Light Corporation for the year ended December 31, 1933.

[198] Haskins & Sells, report to Reynolds Investing Company, Inc., for the year ended December 31, 1935.

* * * During the year 1933, the company reduced the stated value of its common capital stock from $15 to $1 per share and the capital surplus thereby created, together with the balance of earned surplus at December 31, 1932, and a portion of capital surplus previously created, was used to absorb the reduction of the costs of securities owned to market value as of December 31, 1932. The net amount realized in excess of book values, on sales of securities during the year, was determined on the basis of market values established as of December 31, 1932, and/or subsequent costs. * * *[199]

p. Charging of Write-Downs and of the Net Amount of Subsequent Profits and Losses to Capital Surplus Rather Than to Earned Surplus

* * * subject to * * * the charging of losses on sales and write-downs and write-off of investments, etc., to capital surplus * * *.[200]

* * * subject to * * * the charging of the net amount of profits or losses on sales and write-downs or write-offs of investments, etc., to Profit and Loss Reserve representing allocated Capital Surplus * * *.[201]

* * * subject to the charging of the net amount of profits or losses on sales and write-downs or write-offs of investments, etc.; to profit and loss reserve, representing allocated capital surplus, rather than to earned surplus * * *.[202]

q. Company's Established Accounting Policy, as to Which the Accountants Indicated No Dissent

We have examined the books and accounts of Electric Power Associates, Inc., for the year ended December 31, 1933.

In accordance with the Corporation's established accounting policy, all profits or losses realized on the sale of securities since January 1, 1932, all depreciation on securities since January 1, 1930, all stock dividends received since January 1, 1933 valued at closing market prices, and furniture and fixtures written-off, have been charged or credited to capital surplus.

In our opinion, the foregoing Balance Sheet and relative Income and Surplus Accounts correctly show, on the basis stated, the financial condition of the Corporation at December 31, 1933, and the results of operations for the year then ended.[203]

r. Interstate Equities Corporation

Indicative of the consequence of a conflict between management and accountants involving such matters as the determination of the real net worth and of the true income of the company, is the certificate of Price, Waterhouse & Co., accompanying the balance sheet and operating statement of Interstate Equities Corporation of June 30, 1930. The accounting viewpoint of the management prevailed in

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[199] Haskins & Sells report to American International Corporation for the year ended December 31, 1933.

[200] Lybrand, Ross Bros. & Montgomery, report to The Reybarn Company, Inc., for the years ended May 31, 1932 and 1933.

[201] Lybrand, Ross Bros. & Montgomery, report to The Reybarn Company, Inc., for the year ended May 31, 1934.

[202] Lybrand, Ross Bros. & Montgomery, report to The Reybarn Company, Inc., for the year ended May 31, 1935.

[203] Leslie, Bank & Co., report to Electric Power Associates, Inc., for the year ended December 31, 1933.

the balance sheet and operating statement, while the viewpoint of the accountants was stated in their certificate.

A complete verification of a considerable portion of the assets of the company was not made by the accountants as indicated in the accountants' certificate:

Our examination did not cover a complete verification of syndicate transactions and we have therefore been unable to ascertain the depreciation on the participations in syndicates, advances, etc., shown in the balance sheet at $8,450,596.65, and the contingent liability for commitments for syndicate participations.

The statement of financial condition presented to stockholders and investors in final form, accompanied by an accountants' certificate, was not only not based upon a complete verification of a substantial portion of the company's assets, but also omitted the amount of depreciation applicable to these unverified assets, and an amount of contingent liability. That this contingent liability was substantial in amount was indicated in the president's letter included in the report to the stockholders, where it was stated that "* * * there is the following possible contingent liability * * * $4,120,000." The president also stated, "it is impossible to give * * * exact figures," and that it was impossible, also, to give detailed information with respect to the company's syndicate and financing operations. His explanations of the omission to furnish this information, and of his inability to provide the exact amount of the contingent liability, are found in the following excerpt of his letter in the report:

For obvious reasons, it is impossible to give the same detailed information as regards the second part of the corporation's business, namely, the financing operations, as this involves the corporation's relations with associates and clients, which, in many instances, are confidential in nature. However, our Balance Sheet as of June 30th, 1930, showed $8,450,596.65 invested in this account which we have divided for your general information as follows:

$3, 252, 986. 30	is represented by notes maturing in less than one year;
599, 270. 00	is represented by notes maturing in more than one year but not more than two years;
959, 040. 00	in general Bond Syndicates;
1, 155, 223. 65	in general Stock Syndicates;
62, 500. 00	in Commitments in connection with reorganization negotiations;
2, 421, 576. 70	in Commitments in connection with merger negotiations;
8, 450, 596.65	

In addition, there is the following possible contingent liability:

General Bond Syndicates	$2, 474, 000. 00
General Stock Syndicates	1, 209, 000. 00
Reorganization Negotiations	437, 000. 00
	4, 120, 000. 00

As your Corporation in the majority of instances is not Manager of the Syndicates and does not have control of the Syndicate books, it is impossible to give you exact figures as to the amount of the contingent liability or as to the valuation of its shares of the accounts. Your Management feels that it

is a fair assumption to value the notes maturing up to two years at par, and the Bond Syndicates at cost, and estimates a possible depreciation in the stock Syndicates as hereinafter indicated.

The Commitments in negotiations in connection with reorganization and merger work are considered at cost as the Management feels that they are all progressing satisfactorily and along the lines expected when the Commitments were made. None of these undertakings are at a stage of development that make a valuation possible.

In the same letter the president said:

All profits or losses from the sale of securities in the investment portfolio have been left in this account as it is not the policy of your Management to draw any earnings from this source until the investment portfolio has an ample reserve for market fluctuations.

The last quotation referred to the company's practice of not adjusting investment accounts for the cost of shares sold. This procedure tended to conceal the results of trading operations until the last share in the lot was sold. In the interim the profits on sales constituted a hidden reserve, and losses suffered disappeared by their capitalization as additional costs of the shares remaining on hand. The procedure generally accepted was one which ascertained, by the use of one of several methods, the cost of the shares disposed of, which cost became the basis for entering a profit or a loss upon the books when the trade was closed. The accountants took exception to the company's practice by disclosing in the certificate the amount of profit and loss arising from sales of securities, measured on a first-in, first-out basis—a net realized loss of $733,099. The accountant's certificate stated:

The investments shown in the balance sheet at $16,912,753.47 include an amount of $733,099.13 which represents the excess of realized losses over realized gains on sales of securities during the period covered by our examination on the basis of applying first costs against first sales of securities as shown by the company's records. This sum of $733,099.13 forms part of the difference between the book value of investments shown in the balance sheet at $16,912,753.47 and the market value of $15,210,156.94. The investment account also includes securities of a book value aggregating $120,000.00 which were sold at a profit on or prior to June 30, 1930, but for which payment was not received until July 1930.

To this viewpoint of the accountants with relation to the company's trading, the president in his letter, included in the stockholders' report, excepted as follows:

Neither does the Management believe that the theoretical method of computing profits by applying the first sale to the first purchase is a proper one. In a declining market, the first purchases are usually the highest cost purchases, and therefore, when first sales are applied against same, they may show a loss, whereas in many instances the account may show an actual profit; in a rising market, the first purchases are usually the lowest cost purchases, and therefore sales applied against same may show an exaggerated profit. This corporation has adopted the method of accounting which, based upon the President's experience in other large financial institutions, has proven in his judgment the truest test of actual earning power.

Theoretical profits are disregarded—only actual profits appear in the earning statement, and theoretical "realized" profit and loss transactions are not considered as profit and loss. Dividends and interest are not accrued, and

are only credited to earnings when received. The actual condition of the portfolio is given you in this report, based on the valuation method, and thus misleading accounting methods are avoided.

The capitalization of realized losses on an investment by the omission to deduct from investment account a substantial amount of realized losses, gave the published balance sheet and operating statement a misleading and inaccurate quality. This deficiency, together with the failure to verify a substantial portion of the assets, were made subjects of qualifications and exceptions in the accountants' certificate. Whether these qualifications in the certificate could counteract these deficiencies in the statements is problematical.[204]

5. CERTIFICATION OF PROFIT AND LOSS STATEMENT AND OF THE SURPLUS ACCOUNT

A deficiency which also has been commonly cited by the Commission in connection with financial statements filed pursuant to the Securities Act of 1933 and the Securities Exchange Act of 1934, was the failure to certify the profit and loss statement as well as the balance sheet. However, this particular deficiency was not as common as others among the certificates accompanying the published reports issued by the investment companies studied. Although in all reports where balance sheets were presented the correctness of the balance sheet was mentioned specifically in the certificate, there was not this unanimity of practice with reference to the profit and loss statement wherever that statement was presented. In the instances of 10 certificates of four investment companies the correctness of this operating statement was not specified in the accountants' certificates.[205]

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[204] A certificate of the kind just presented would be scrutinized today not only in the light of the requirements of the Securities Act of 1933 and the Securities Exchange Act of 1934, and of the Commission's instructions in Regulation S–X, reproduced hereinbefore, but also after consideration of the following statement of the administrative policy of the Commission with respect to financial statements, as expressed in Accounting Series Release No. 4, issued on April 25, 1938:

"In cases where financial statements filed with this Commission pursuant to its rules and regulations under the Securities Act of 1933 or the Securities Exchange Act of 1934 are prepared in accordance with accounting principles for which there is no substantial authoritative support, such financial statements will be presumed to be misleading or inaccurate despite disclosures contained in the certificate of the accountant or in footnotes to the statements provided the matters involved are material. In cases where there is a difference of opinion between the Commission and the registrant as to the proper principles of accounting to be followed, disclosure will be accepted in lieu of correction of the financial statements themselves only if the points involved are such that there is substantial authoritative support for the practices followed by the registrant and the position of the Commission has not previously been expressed in rules, regulations, or other official releases of the Commission, including the published opinions of its Chief Accountant."

Also in this connection, the American Institute of Accountants in its bulletin, "Extensions of Auditing Procedure," dated October 18 1939, stated: "If * * * exceptions are sufficiently material to negative the expression of an opinion, the auditor should refrain from giving any opinion at all, although he may render an informative report in which he states that the limitations or exceptions relating to the examination are such as to make it impossible for him to express an opinion as to the fairness of the financial statements as a whole.

[205] The 10 certificates which omitted this specification were as follows:

	Annual reports of—
State Street Investment Corporation	1927 and 1928
Prudential Investors, Inc	1929 and 1930
Investors Equity Company, Inc	1930
The Reybarn Company, Incorporated	1930 to 1934, inclusive

In the standard form of certificate, the opinion of the accountant is expressed with reference to "the accompanying balance sheet and related statements of income and surplus." Thus, the certification applied also to the statement of surplus. In 1935, only six of 53 certificates contained in reports of investment companies in which surplus accounts were published failed to include the surplus account, as such, in the certification. However, in earlier years, omissions were far more numerous (Table 69).

TABLE 69.—*Certification of surplus in accountants' certificates, 1927–35*

Year ended in—	Number of certificates referring specifically to surplus account	Number of certificates making no reference to surplus account	Number of reports which did not include a surplus account	Year ended in—	Number of certificates referring specifically to surplus account	Number of certificates making no reference to surplus account	Number of reports which did not include a surplus account
1927	1	9	----------	1933	43	16	2
1928	2	21	----------	1934	52	12	2
1929	14	27	----------	1935	47	6	2
1930	23	28	----------				
1931	41	15	1	Total certificates	260	151	9
1932	37	17	2				

6. VERIFICATION OF CASH BALANCES SPECIFIED IN ACCOUNTANTS' CERTIFICATES

The certificates reviewed failed to contain a reasonably comprehensive statement as to the scope of the audit, particularly with reference to the verification of cash and securities. The standard form of certificate adopted early in 1934 contained the notation, numbered 4, which reads:

> In the second sentence, any special forms of confirmation could be mentioned: e. g., "including confirmation of cash and securities by inspection or certificates from depositaries."

An analysis of the certificates throughout the entire period 1927–1935 indicates that references to the confirmation of cash were rare prior to 1930, but increased subsequent to 1930. However, as late as 1935, although in these later years the standard form referred to such confirmation, the certificates which omitted such a reference exceeded the number containing such a reference. (See Table 70.)

TABLE 70.—*Reference to verification of cash balances in accountants' certificates, 1927–35*

Year ended in—	Method of confirmation specified	Method of confirmation not specified	Year ended in—	Method of confirmation specified	Method of confirmation not specified
1927	2	8	1933	14	47
1928	3	20	1934	23	43
1929	5	36	1935	23	32
1930	7	44			
1931	11	46	Total certificates	101	319
1932	13	43			

7. VERIFICATION OF PORTFOLIO SECURITIES

Table 71 indicates the number of certificates which contained a reference with respect to the verification of portfolio securities and the manner in which this verification was made.

TABLE 71.—*Reference to verification of portfolio securities in accountants' certificates, 1927–35*

Method of verification	1927	1928	1929	1930	1931	1932	1933	1934	1935	Total
1. By physical inspection	------	1	------	1	2	3	3	4	2	16
2. By confirmaton with depositary	2	2	3	8	13	12	16	17	16	89
3. By inspection and/or confirmation	1	3	4	12	10	12	14	15	16	87
4. By undisclosed method	1	2	5	6	9	6	4	5	5	43
Total certificates specifying that portfolio securities were verified	4	8	12	27	34	33	37	41	39	235
Certificates containing no mention of verification	6	15	29	24	23	23	24	25	16	185
Total certificates	10	23	41	51	57	56	61	66	55	420

A substantial number of the certificates contained no mention that the custody of the securities was verified. Where such confirmation was indicated, confirmation with the despositary was the most widely used method of verification. The efficacy of this method necessarily depends upon the financial responsibility of the depositary as well as the relationship of such depositary to the investment company rendering the report. Where the custodian is closely related to the company, such as sponsor or manager of the affairs of the company under audit, such confirmation may be inadequate. For example, in the case of three investment companies managed by C. D. Parker & Co., Inc., this sponsoring company converted approximately $250,000 of the portfolio securities of the three investment companies by hypothecating them as collateral for its own loans. The accountant's failure to check physically the possession of the portfolio securities of the investment companies enabled the sponsor to conceal its conversion of

these securities. As confirmation of physical custody of portfolio securities, the accountant accepted letters of confirmation from C. D. Parker & Co., Inc., as to the investment company securities in its custody as if they were the equivalent of letters of confirmation from a nonaffiliated bank. The accountant justified his position by claiming that it was not part of his job to go behind the letters of confirmation and physically check the securities, although the letters of confirmation came from the sponsor and manager of the investment companies whose transactions with the companies had to be checked.[206]

8. ACCOUNTANTS' CERTIFICATES ADDRESSED TO STOCKHOLDERS, 1927–35

Table 72 indicates that of all the accountants' certificates under review covering a period of nine years, about 5% of the 420 certificates examined were addressed to stockholders; the balance were addressed to the company or to its board of directors. In 1935, 10% of the certificates of that year were addressed to the stockholders. Appended to the earlier form of the standard accountant's certificate was the following note:

> The report [accountant's certificate] should be addressed to the directors of the company or to the stockholders if the appointment is made by them.

This rule is the same in connection with the revised standard form.[207]

TABLE 72.—*Accountants' certificates addressed to stockholders*

Year ended in—	Number addressed to stockholders	Number not addressed to stockholders	Year ended in—	Number addressed to stockholders	Number not addressed to stockholders
1927		10	1933	4	57
1928		23	1934	4	62
1929		41	1935	5	50
1930	1	50			
1931	4	53	Total certificates	22	398
1932	4	52			

[206] Since C. D. Parker & Co., Inc., was a depositary for several investment trusts, then only simultaneous audits of all the investment trusts for which the firm was depositary would have proven the securities of each, unless, of course, there was some sort of physical segregation or identification of the securities of each trust. One of the dangers of attempting to count securities physically when they are on deposit with the depositary is that there may be little way that the accountant can be sure that the securities he is given to count are those of his trust and are not being used by the depositary to satisfy auditors of other trusts as well.

For detailed discussion of the companies sponsored by C. D. Parker & Co., Inc., see Ch. II of this part of the report, pp. 76–93.

[207] See "Extensions of Auditing Procedure," American Institute of Accountants, October 1939.

9. INTERVAL BETWEEN YEAR-END AND DATE OF ACCOUNTANTS' CERTIFICATES

An analysis of the interval between the year-end and the date of the certificates indicates that the tendency has been to shorten the interval between the year-end and the time when the information is made available to the stockholders. Thus, for 1930, 20% of the certificates were dated more than 30 days from the end of the year, as contrasted with only 11% for 1935. (See Table 73.)

TABLE 73.—*Interval between fiscal year-end and date of accountants' certificates, 1927–35*

Year	Interval (in days)					Not dated	Total
	1–15	16–30	31–45	46–60	Over 60		
	Number of certificates						
1927	2	4	1	2	--------	1	10
1928	5	12	3	1	--------	2	23
1929	12	12	7	5	1	4	41
1930	17	21	8	2	--------	3	51
1931	21	23	6	4	1	2	57
1932	19	24	5	3	1	4	56
1933	23	22	8	3	1	4	61
1934	28	24	3	8	2	1	66
1935	32	16	5	1	--------	1	55
Total	159	158	46	29	6	22	420

10. SEABOARD UTILITIES SHARES CORPORATION, RAILROAD SHARES CORPORATION, AND UTILITIES HYDRO & RAILS SHARES CORPORATION—C. D. PARKER & CO., INC., SPONSOR

The extent to which published financial statements certified by certified public accountants can be misleading is illustrated in the cases of the three investment companies, Seaboard Utilities Shares Corporation, Railroad Shares Corporation, and Utilities Hydro & Rails Shares Corporation which were sponsored in 1929 by C. D. Parker & Co., Inc., of Boston, Massachusetts. Approximately $25,000,000 of capital was raised by these three investment companies. C. D. Parker & Co., Inc., commenced to experience financial difficulties in the latter part of 1929. Its financial condition became progressively worse, and in 1935 the company went into receivership.[208]

[208] For detailed discussion of these companies, see Ch. II of this part of the report, pp. 76–93, Sec. II. Seaboard Utilities Shares Corporation, after being organized in March 1929 under the laws of Massachusetts, was reorganized in January 1930 under the laws of Delaware. The sum of $16,525,000 was raised as capital for this company. Railroad Shares Corporation was organized in July 1929 under the laws of Massachusetts, for which company $6,767,000 was obtained as capital. Utilities Hydro & Rails Shares Corporation was organized in November 1929 under the laws of Delaware, for which company $1,573,508

The public accounting firm of Charles E. Stanwood & Sons, Inc., of Boston, Massachusetts, was engaged to act as auditors for the three investment companies by Bowen Tufts, who was not only a vice president and managing director of each of the three investment companies, but was also a vice president, general manager and one of the six largest stockholders of C. D. Parker & Co., Inc.

The accounting firm issued two reports in connection with the audit of each of the three companies. One report, addressed to Bowen Tufts, contained analyses, explanatory notes, and comments without which the true substance of the items contained in the financial statement could not be ascertained. The other report of the same audit, addressed to the company and prepared for publication, omitted these analyses and comments. As a result, the published financial statements were deficient and misleading in a number of material respects over a period of years.

C. D. Parker & Co., Inc., not authorized to act as a bank of deposit, acted as the principal depository of the cash funds of the companies, against which deposits checks were drawn. Also, cash was deposited by the investment companies with the sponsor against which "Certificates of Deposit" were issued, and as "Funds Reserved for the Purchase of Securities under Order."

The published financial statements were bare of any details which would indicate that cash balances were held, and that the certificates of deposit were issued, by a company whose principal business was that of underwriter and distributor of securities and not that of a bank. C. D. Parker & Co., Inc., maintained checking accounts for no corporations except the three investment companies.

At December 31, 1930, as much as 61% of the total of the companies checking account balances was held by C. D. Parker & Co., Inc. At the subsequent year-ends, 1931 to and including 1933, practically all the funds of the companies were on deposit with their nonbanking sponsor which was undergoing a financial crisis in its affairs. A clear indication of the sponsor's financial weakness was evident in April 1932. At this date, loans of Seaboard Utilities Shares Corporation with banks, aggregating $1,285,000, secured by collateral, were called. As a result, the collateral which comprised fully 80% of the company's portfolio was sold, and a loss of more than $6,000,000 was suffered by the company. At the time the banks called these loans of $1,285,000, the sum of $1,270,000 was on deposit with C. D. Parker & Co., Inc. Had this money been paid to the banks, it would have been sufficient to satisfy approximately the company's entire indebtedness. Thus a substantial part of its assets might have been conserved. The reasons for this failure to pay the loan were not disclosed.

Table 74 indicates the details of the companies' cash balances with the sponsor during the period of its financial difficulties.[209] The table also indicates the companies' treatment in the certified published statements of commingling in one amount (described deceptively as "cash in banks and on hand" or as "cash") the negligible amount in

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was secured as capital. C. D. Parker & Co., Inc., was an underwriter and distributor of securities located in Boston, Massachusetts. C. D. Parker was a member of the Boston Stock Exchange through which the firm traded. The three companies and their sponsor, C. D. Parker & Co., Inc., were placed in receivership early in 1935.

[209] These details were furnished in the accountants' reports submitted to Bowen Tufts but were omitted from the certified published reports.

banks with the large amount due from its sponsor which was not a bank.

In addition, the certified published financial statements of the three companies carried an item described as "certificates of deposits" at each of the year-ends 1931, 1932, and 1933, in the following amounts:

Statements of—	*Amounts of certificates of deposit*
Seaboard Utilities Shares Corporation	$875,000
Railroad Shares Corporation	300,000
Utilities Hydro & Rails Shares Corporation	120,000
Total	1,295,000

No mention was made in the certified published reports that these "certificates of deposit" were issued by C. D. Parker & Co., Inc., in December 1931.[210] Since the description "certificates of deposit" is usually associated with those issued by banking institutions supervised by governmental authorities, the failure to reveal the name and business of the issuer of the certificate, which was not a bank, was misleading.[211]

The third item of the companies' cash in the possession of the sponsor was that described as "funds reserved for the purchase of securities under order." The record in this respect at each year-end, 1930 to and including 1933, was as follows:[212]

[210] This detail was recited in the accountants' reports submitted to Bowen Tufts.

[211] Some of the directors of these investment companies were misled completely by the description of the cash items contained in the published financial statements. J. Lewis Henry, who was a director of Seaboard Utilities Shares Corporation and of Utilities Hydro & Rails Shares Corporation, testified in this connection as follows (Public Examination, C. D. Parker & Co., Inc., at 21050):

Q. Did you ever receive any financial statements?

A. No; I never received any financial statements other than that which maybe was made public which was mailed to stockholders—never a detailed audit in any shape or form.

Q. You found an abbreviated statement or balance sheet giving you some resultant figures and a break-down?

A. Yes.

Q. Three certificates of deposit were listed on that statement. You never knew whether the certificates of deposit were issued by the National Shawmut Bank of Boston or by whom it was issued. Isn't that so?

A. That is correct.

Q. You thought that, if I am not mistaken, some bank authorized by the banking laws did issue these certificates of deposit?

A. It is my exact recollection that all fiduciary activities were segregated—securities and cash—entirely apart from C. D. Parker & Co., and that was always my impression until today. I never knew otherwise.

Q. You never knew that C. D. Parker was acting as depository for this cash?

A. No; never, until about a week or two ago.

Q. And certainly not to issue certificates of deposit?

A. No, sir.

Q. In fact, you received a letter to which you could not reply from the stockholder Lang concerning these certificates of deposit of 875 thousand dollars [held by Seaboard Utilities Shares Corporation]?

A. Exactly so.

Q. So it was not strange that Lang should not know about those certificates of deposit because you yourself, in name a director, did not know. Isn't that so?

A. That is exactly so. The more so because I had been one of the probably half dozen, that was probably so-called key dealers. I had sponsored a great deal of wholesaling to other dealers. And due to the chaos existing in those later years they were constantly hounding me for information which I was unable to get for them. It was not only individuals but brokers, dealers, and banks as well.

[212] Public Examination, C. D. Parker & Co., Inc., Commission's Exhibits Nos. 3232, 3234, and 3237.

TABLE 74.—*Treatment of cash in certified published statements of Seaboard Utilities Shares Corporation, Railroad Shares Corporation, and Utilities Hydro & Rails Shares Corporation, 1930–33* [a]

Name of company	Year ended Dec. 31—	Description (Break-down not furnished in published reports)			Total cash	Total of cash item described as follows in published reports, or concealed when combined with so-called collateral loans
		Cash on hand	Cash in banks	Due from C. D. Parker & Co., Inc.		
Seaboard Utilities Shares Corporation.	1930	$25	$192, 560. 64	$189, 677. 75	$382, 263. 39	Cash in banks and on hand.
	1931	25	6, 444. 99	30, 420. 73	36, 890. 72	Do.
	1932	25	5, 457. 28	566, 440. 68	571, 922. 96	Do.
	1933	25	2, 863. 97	651, 135. 21	654, 024. 18	Do.
Railroad Shares Corporation	1930	25	96, 992. 12	202, 501. 69	299, 518. 81	Cash and time loans secured by collateral.
	1931	25	5, 746. 03	67, 898. 56	73, 669. 59	Do.
	1932	25	8, 653. 49	180, 108. 91	188, 787. 40	Do.
	1933	25	1, 222. 80	202, 722. 81	203, 970. 61	Do.
Utilities Hydro & Rails Shares Corporation.	1930	25	6, 174. 70	67, 237. 45	73, 437. 15	Cash and collateral loan.
	1931	25	2, 676. 22	66, 362. 47	69, 063. 69	Cash in banks and on hand.
	1932	25	662. 80	175, 015. 08	175, 702. 88	Do.
	1933	25	2, 255. 09	195, 076. 63	197, 356. 72	Do.
Totals, above three companies	1930	75	295, 727. 46	459, 416. 89 (61% of total)	755, 219. 35	
	1931	75	14, 867. 24	164, 681. 76 (92% of total)	179, 624. 00	
	1932	75	14, 773. 57	921, 564. 67 (98% of total)	936, 413. 24	
	1933	75	6, 341. 86	1, 048, 934. 65 (99% of total)	1,055,351.51	

[a] Derived from public examination, C. D. Parker & Co., Inc., Commission's Exhibits Nos. 3232, 3234 and 3237; *Keane's Manual of Investment Trusts*, 1931; and *Moody's Manual of Investments, Banks, etc.*, 1933, 1934 and 1935.

Funds reserved for the purchase of securities under order at year-ends

	1930	1931	1932	1933
Seaboard Utilities Shares Corp	$416, 067. 58	$396, 491. 85	$414, 969. 87	$436, 409. 88
Railroad Shares Corp	405, 609. 43	415, 451. 98	434, 802. 54	457, 161. 51
Utilities Hydro & Rails Shares Corp	225, 472. 34	210, 025. 59	219, 074. 30	230, 292. 43
Total	1, 047, 149. 35	1, 021, 969. 42	1, 068, 846. 71	1, 123, 863. 82

The following table is a recapitulation of the funds of the companies in the hands of their sponsor under the three classifications of "cash," "certificates of deposit," and "funds reserved for the purchase of securities under order," at the year-ends 1930 to and including 1933.

Funds of the three investment companies in possession of C. D. Parker & Co., Inc., at year-ends

Description	1930	1931	1932	1933
Cash	$459,416.89	$164,681.76	$921,564.67	$1,048,934.65
Certificates of deposit		1,295,000.00	1,295,000.00	1,295,000.00
Funds reserved for the purchase of securities under order	1,047,149.35	1,021,969.42	1,068,846.71	1,123,863.82
Total	1,506,566.24	2,481,651.18	3,285,411.38	3,467,798.47

The functioning of these three cash accounts was described by the accountant, A. T. Stanwood, as follows:[213]

Q. With respect to these certificates of deposit, the interest as it accrued was not paid to the trust but was carried as part of the balance in the account, is that right?

A. I couldn't say definitely on that. I would say that a good proportion was credited to the account. Some I believe was paid.

Q. These special funds that were deposited to pay for the securities under order, those funds were augmented by the retention of the proceeds received by the sponsor on the sales of securities, weren't they?

A. Right.

Q. Which was rather unusual for an account which was supposed to be used to purchase securities under order.

A. That is correct.

Q. You would normally find an account in which funds were deposited for such purpose, gradually being eaten up through the purchase of securities.

A. That would be the tendency with the account.

Q. But instead in C. D. Parker & Company this fund kept swelling all the time, isn't that so?

A. That is right.

Q. And with respect to the checking accounts that were opened with the sponsor, those were increased as of year-ends right regularly on through the period of operation of these trusts.

A. The tendency was to increase.

The increase of the amount of the companies' cash held by their sponsor coincided with the increase in the distress of the sponsor's financial affairs.

The extraordinary functioning of these cash accounts required that these purportedly liquid assets be reclassified in the financial statements as frozen items, and required also that qualification be made by the accountants in their certificates to reflect the uncollectible character of the items. This was obligatory in view of the staleness of the "certificates of deposit"; the permanency of the item, despite the temporary character of the described purpose of the "funds reserved for the purchase of securities under order"; and the unavailability of any appreciable part of these funds, or of the balances in

[213] Id., at 21017–8.

the checking accounts, in emergencies.[214] In addition, the accountants had some intimation of the financial weakness of C. D. Parker & Co., Inc. A. T. Stanwood, a representative of the certifying accountants, testified:[215]

Q. Were you oblivious as to the financial condition of C. D. Parker & Co., Inc., in 1933?

A. Why I had some idea.

Q. Didn't you have a pretty good notion that C. D. Parker & Co. was fairly well on the rocks?

A. Well, only from gossip around the street.

Neither the financial statements of the three companies published for the year-end 1933, which contained cash items aggregating $3,467,798, representing approximately 80% of the listed assets,[216] nor the accountants' certificates, furnished any clue of the worthlessness of the bulk of the reported assets.

No published financial statements later than that for the year-end 1933 have been found.[217]

When the three investment companies, together with their sponsor, were placed in receivership in 1935, it was discovered that practically the remainder of the companies' portfolios was pledged with banks to secure loans of their sponsor, C. D. Parker & Co., Inc. This conversion of the companies' securities would have been discovered had the accountants, in the course of their audits not relied upon the letter of confirmation from the sponsor that the securities were in its care and possession.

In addition, aspects of the item described as "time loans secured by collateral" which appeared on the published certified statements of Railroad Shares Corporation for the 1929 and 1930 year-ends were

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214 For example, in April 1932, $1,270,000 of the cash of Seaboard Utilities Shares Corporation was supposed to be in the hands of its sponsor, yet practically the entire portfolio of Seaboard Utilities Shares Corporation was sacrificed at a loss of $6.000,000 to pay the bank loans called in the amount of $1,285,000.

215 Op. cit. supra, note 215, at 20995.

216 The total market value of the portfolios at this date, the only other important asset, was $455,377 (id., Commission's Exhibits Nos. 3232, 3234, and 3237):

Seaboard Utilities Shares Corporation	$312, 507
Railroad Shares Corporation	50, 854
Utilities Hydro & Rails Shares Corporation	92, 016
Total	455, 377

217 As stated in Ch. II of this part of the report, Sec. II:

"* * * when the Banking Act of 1933, compelling the divorcement of private and commercial banking from investment banking, went into effect on June 17, 1934, the three investment companies had $3,139,608 with their sponsor, of which $1,989,527.24 was in cash deposits in checking accounts and certificates of deposit. Since C. D. Parker & Co., Inc., was engaged in the investment banking business, it was required to return to the investment companies the $1,989,527.24 on deposit with itself. However, at this time the sponsor was insolvent and these cash deposits were not turned over to the investment companies. Instead the sponsor changed the designation of all deposit accounts, then aggregating $3,139,608.78, describing them as 'Funds reserved for the purchase and sale of portfolio securities under order' and as 'Funds reserved for the purchase and sale of treasury shares under order.' * * * By December 31, 1935, the sponsor was indebted to the three investment companies in the aggregate sum of $3,304,776.62. Actually C. D. Parker & Co., Inc., was insolvent and with its ensuing bankrupty virtually the entire amount of these 'deposits' was, in the opinion of Mr. Stanwood, lost to the stockholders of the investment companies."

misleading. The amount finally involved in this item was $3,233,000, which represented neither time loans nor any collateral. In fact, the amount represented 323,000 shares of the capital stock of the company, which remained unsold in the hands of the distributor, C. D. Parker & Co., Inc., and which it held at an option price of $10 per share without any liability or obligation upon that company or any other person for the price while unsold. Likewise, the capital stock account of Railroad Shares Corporation was inflated by the amount of $3,233,000 for shares not duly issued.

The explanation of the certification without qualification of these financial statements of the three Parker sponsored companies may be found in the absence of independence of the accountants from the management represented by Bowen Tufts. A. T. Stanwood, the accountant who conducted the audits, testified: [218]

Q. Now, what do you understand the obligation of an accountant for an investment trust to be? When the investment trust hired your firm, to whom were you answerable in your conscience?

A. Mr. Bowen Tufts.

Q. You say you were answerable only to Mr. Bowen Tufts?

A. He engaged us to do that work and make certain examinations of those financial audits only, and report to him.

Q. Now, did you feel any obligation on the part of your firm as accountants for these trusts, to the shareholders of the trusts?

A. Only insofar as that information would clear through the manager director, Mr. Tufts.

* * * * * * *

Q. Now, in performing that duty [of a public accountant], don't you think that the primary obligation on your part was to tell to the stockholders, through the instrumentality of your reports, exactly what was transpiring with respect to their funds in those trusts, in the language of accounting?

A. If it was permitted by the managing director.

Q. You mean that your managing director prohibited you from giving authentic reports and clear and unequivocal reports to your stockholders?

A. No; I did not say that.

Q. Well, what is the insinuation of your last remark?

A. I say that in certain of the wording of our reports that were presented to him [Bowen Tufts] there were certain things that I could not put in there.

Q. For example.

A. For example, you read a footnote a few minutes ago "certain of these securities" [are pledged as collateral on Notes Payable and amounts owing for purchase of securities]; I had the amount of those securities in there.

Q. You did have?

A. I was not permitted to put that in.

Q. You were not?

A. No, sir.

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[218] Op. cit. supra, note 215, at 20985. A. T. Stanwood, who was not a certified public accountant, conducted the audits in behalf of the firm of Charles E. Stanwood & Sons, Inc., under the supervision of his father, Charles E. Stanwood, a certified public accountant of Massachusetts, and a member of the American Institute of Accountants. Other members of the firm were James C. Hall and Frank J. Goldberg, both certified public accountants. The latter was a member of the Massachusetts Society of Certified Public Accountants. (Id., at 21041–2 and 20974.)

Q. Because the amounts would have shown that over 80 per cent of the whole trust was in the bank as collateral for loans?

A. I don't know the percentage but it was substantial.

* * * * * * *

Q. So that the bank virtually owned the trust for that loan?

A. I should say so.

Q. Yet the stockholders did not know that, isn't that so?

A. That is right.

This testimony related to the published statement of Railroad Shares Corporation as at December 31, 1930. The accountants' certificate which accompanied this statement was in the following form: [219]

We hereby certify that we have examined the books of account of Railroad Shares Corporation, and, in our opinion, the attached Balance Sheet, subject to notations therein,[220] correctly sets forth the financial condition as at December 31, 1930.

Charles E. Stanwood and Sons, Inc.
By Charles E. Stanwood
Certified Public Accountant (Mass.)

This financial statement for which the accountants' certificate made no qualifications to guard the investors from making wrong interpretations, was misleading in the following respects:

(1) The item described as "Cash and Time Loans Secured by Collateral" in the amount of $3,532,518.81, was comprised of (a) cash of only $299,518.81, of which $202,501.69 was on deposit not with a bank, but with C. D. Parker & Co., Inc., and (b) the amount of $3,233,000 represented not a time loan or any collateral, but an item of 323,300 shares of the capital stock of the company unsold in the possession of C. D. Parker & Co., Inc., which it held at an option price of $10 per share but without any liability for the price while unsold.

(2) Capital stock account stated in the amount of $10,000,000 was inflated by $3,233,000 representing 323,300 shares not duly issued.

(3) The statement omitted to specify the value of securities pledged with banks upon loans, so that investors were not informed that a substantial portion of the portfolio was pledged as collateral.

(4) The statement failed to reveal that the item of $405,609.43 described as "Funds Reserved for Payments of Securities under Order," actually represented cash on deposit with the non-banking sponsor, C. D. Parker & Co., Inc., and not with a legitimate bank of deposit.

All published financial statements of the three investment companies were accompanied by accountants' certificates signed by Charles E. Stanwood & Sons, Inc. That the published statements did not accurately reflect the true condition of affairs, as vouched for in the certificates, was admitted by A. T. Stanwood as follows: [221]

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[219] Id., Commission's Exhibit No. 3231.

[220] The following are the notations referred to:

1. "Certain of these securities are pledged as collateral on Notes Payable and amounts owing for purchase of securities."

2. "Of these, 2,000,000 are reserved for the conversion of stock purchase warrants—issued and unissued."

3. "Note. The liquidating value of 838,061 shares outstanding is $7.59 per share as of December 31, 1930, using market closings as of January 27, 1931, was $8.08."

[221] Op. cit. supra, note 215, at 21040–1.

Q. And those condensed reports [222] are certified by you, aren't they?

A. That is right.

Q. And yet, strictly speaking—I am now talking of these reports which are in evidence—they do not enlighten the stockholder.

A. In certain instances they may not.

Q. In connection with the cash on hand and on deposit, you use the expression "banks" in your condensed version. The banks held less than 6 percent of the total deposits. C. D. Parker held over 95 percent * * *. So that I think you will agree with me that these abbreviated versions translating the condition of companies that are given to stockholders should more accurately reflect the true condition of affairs.

A. No question about it.

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[222] This refers to the published reports which omitted the comments explaining the true substance of the items on the balance sheet contained in the report addressed to Bowen Tufts.

II. DESCRIPTION OF THE ACTIVITIES OF THE UNITED FOUNDERS CORPORATION GROUP

A. Introduction

The United Founders Corporation group consisted of 13 [1] closely affiliated companies, which had at the end of 1929, paid-in capital of approximately $503,827,000,[2] contributed by more than 90,000 stockholders located primarily in 35 states of the United States and in foreign countries.[3] Of the 13 companies in the immediate United Founders Corporation group, three have been made the subject of separate parts of this report,[4] and this section of the report will be limited largely to a discussion of the remaining 10 companies.

The 13 companies of the United Founders Corporation group had numerous other companies loosely affiliated with them largely through stock ownership, and the group was by far the largest group of invest-

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[1] These 13 companies were:

United Founders Corporation.
American Founders Corporation (formerly American Founders Trust).
International Securities Corporation of America (formerly International Securities Trust of America).
Second International Securities Corporation.
United States & British International Company, Ltd.
American & General Securities Corporation.
American and Continental Corporation.
Investment Trust Associates.
Founders Associates.
Founders General Corporation.
General Investment Corporation (formerly The Public Utility Holding Corporation of America).
United States Electric Power Corporation, and
United States & Overseas Corporation (Public Examination, American General Corporation, et al., at 22011–6, 22078–116, 22190–5, 22742–3, 22830, and 26506–9).

[2] By the end of 1929 the 13 companies of the United Founders Corporation group had issued securities for $686,165,000, of which securities having a paid-in value of $182,338,000 were held intercorporately by the group. (Id., Commission's Exhibit No. X3424–C.)

[3] Id., at 22160–1. There were one or two stockholders in each of several other states as well. (Ibid.) This number does not include the stockholders of various affiliated companies sponsored by United Founders Corporation nor the holders of the $52,447,200 outstanding debentures issued by companies of the United Founders Corporation group. (Ibid., and Commission's Exhibits Nos. X3402 (p. 6), X3404 (p. 6), X3420 (E–2), X3407 (p. 6), X3409 (p. 6), X3411 (p. 6), and X3418 (F–18).)

[4] United States Electric Power Corporation, a utility holding company, was jointly sponsored by the United Founders Corporation group and others, in September 1929. In 1930 United Founders Corporation acquired voting control, although it shared the management with the remaining original sponsors until late in 1935, when it distributed the stock of United States Electric Power Corporation, which it held, to its own stockholders. United States Electric Power Corporation has been made the subject of a separate discussion because of its noninvestment company character. (See Pt. Four of this report.) General Investment Corporation, formerly The Public Utility Holding Corporation of America, was also formed in September 1929. It was sponsored by the United Founders Corporation group and Harris, Forbes & Co., which actively managed it until 1932. Because of the distinctly different management given General Investment Corporation and its subsidiary, United States & Overseas Corporation, by Harris, Forbes & Co., they have been made the subject of separate study in Ch. II of this part of the report (pp. 497–623) in spite of the fact that the United Founders Corporation group was the largest single stockholder and in 1935 held a majority voting control of the enterprise.

ment enterprises in the United States. In all, there were affiliated with the United Founders Corporation 22 investment companies including hybrids of investment company and holding company and hybrids of investment company and intermediate credit company.[5] Of these, 14 were organized under the exclusive or joint sponsorship of the United Founders Corporation group as constituted at the time.[6] These investment companies in turn at one time or another effectively dominated seven security distributing enterprises[7] and at least 16 other companies, including nine utility holding companies,[8] the largest of which,

[5] Investment companies and hybrid investment companies and holding companies or investment companies and intermediate credit companies which were affiliated with the United Founders Corporation group included:

United Founders Corporation.
American Founders Corporation.
International Securities Corporation of America.
Second International Securities Corporation.
United States & British International Company, Ltd.
American & General Securities Corporation.
United States and Overseas Corporation.
American and Continental Corporation.
General Investment Corporation.
Investment Trust Associates.
Founders Associates.
Trans-Oceanic Trust, Ltd.
North and South American Corporation.
Colombian Investment Corporation.
International and General Corporation.
United National Corporation.
Aeronautical Industries, Inc.
National Aviation Corporation.
Insuranshares Corporation of Delaware.
Insuranshares and General Management Co.
Insuranshares Certificates, Inc., and
Reliance Management Corporation (Op. cit. supra, note 1, at 22079, 22109–12, 26519–24, 22138–9).

[6] In addition, the United Founders Corporation group organized or participated in the organization of the following noninvestment company enterprises affiliated with the group:

United States Electric Power Corporation.
Founders General Corporation.
Southeastern Gas and Water Company,
Midland Natural Gas Company,
Twin States Natural Gas Company,
American Founders Office Building, Inc.,
Societe L'Hydro-Energie.

(Op. cit. supra, note 1, at 22114, 26558–61 and Commission's Exhibit No. X3404, E–1 (p. 8). See Ch. II of this part of the report, pp. 497 et seq., for the participation of General Investment Corporation in the organization of Societe L'Hydro-Energie.)

[7] The following 4 security distributors were at one time or another operated as distributing affiliates of the United Founders Corporation group:

W. R. Bull and Company, Inc.,
Founders General Corporation,
Bond & Goodwin, Inc.,
Allied General Corporation—formerly Insuranshares Corporation (New York).

In addition, the affiliated United National Corporation effectively controlled Drumheller, Ehrlichman & White, Murphey Favre & Co. and Ferris & Hardgrove, three investment banking enterprises operating on the Pacific Coast. (Op. cit. supra, note 1, at 22026–7, 22084–5, 22139–40 and Commission's Exhibit No. X4195 at J and N.)

[8] Through stock ownership the United Founders Corporation group had directly a dominant interest in the following utility holding companies and miscellaneous companies:

Washington and Suburban Companies (formerly Seaboard Investment Trust),
Southeastern Gas and Water Company (formerly Inland Utilities, Inc.),
United States Electric Power Corporation,
Midland Natural Gas Company,
Public Utility Associates, Inc. (formerly The Harris Forbes Corporation),
Bridgeport Rolling Mills, Inc.,
American Founders Office Building, Inc.,
H. N. Stronck & Co., Inc.,
Twin States Natural Gas Company.

Footnote 8 continues on p. 2110.

United States Electric Power Corporation, held joint control of the billion dollar Standard Gas and Electric Company utility empire.[9] The resources so dominated by the United Founders Corporation group were at one time in excess of $2,100,000,000.[10]

Control of the United Founders Corporation group changed from time to time during its 14 years of existence. In January 1922, Christopher Foster Coombs, then a bankrupt[11] investment dealer in Boston,[12] and William R. Bull,[13] a security dealer of limited resources

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(Id., at 25579–82, 22114, 26558–61, 22138–9, 22026–7 and Commission's Exhibit No. X3404–E–1 [p. 8].)

In addition, through General Investment Corporation, the United Founders Corporation group had a dominant interest in:

Central Public Service System,
American Commonwealths Power Corporation,
Central West Public Service Company,
Indiana Consumers Gas & By-Products Co.,
Cuba Company,
L'Union Electrique Rurale,
Societe L'Hydro-Energie.

(A separate report of General Investment Corporation has been included in this part of the report, Ch. II, pp. 497 et seq.)

[9] For the history of the control of the Standard Gas and Electric system from 1920 to 1936 see Pt. Four of this report.

[10] On November 30, 1930, the United Founders Corporation had consolidated resources of $296,815,019.13 after eliminating $35,820,703.85 intangibles. (Op. cit. supra, note 1, Commission's Exhibit No. X3420, E–5 [p. 12].) These $296,815,019.13 assets included $96,061,540.35 investments in United States Electric Power Corporation and General Investment Corporation (id., Commission's Exhibit No. X3421 [p. 62]) so that exclusive of the investment in United States Electric Power Corporation and General Investment Corporation, the resources of the United Founders Corporation group were in excess of $200,500,000. At that time United States Electric Power Corporation had joint control of the $1,100,000,000 Standard Gas and Electric System and General Investment Corporation had a dominant interest in enterprises with resources in excess of $820,000,000. (For reports of United States Electric Power Corporation and General Investment Corporation see Pt. Four and Ch. II of this part of the report, p. 497 et seq., respectively.)

[11] William R. Bull testified that at the time of the organization of Weeks, Lewis & Bull Company in 1922 he knew Coombs to be in bankruptcy. (Op. cit. supra, note 1, at 22011 and 22229.)

[12] Frank B. Erwin testified that Mr. Coombs, who had previously been in business in Boston, Massachusetts, as a security dealer (owning C. F. Coombs & Company), in 1914 became a partner with Mr. Erwin and others in Megargel & Company, an investment banking firm doing business in New York, Chicago, and Boston. In this enterprise Mr. Coombs held a 15–16% interest. Shortly after the World War Megargel & Company was forced into liquidation, and in connection therewith both Erwin and Coombs filed petitions in bankruptcy. (Id., Commission's Exhibit No. X3737, pp. 5–9.) Although Mr. Coombs determined the issue price for the stock of Weeks, Lewis & Bull Company (id., at 22279), and acted as investment manager for both Weeks, Lewis & Bull Company and International Securities Corporation of America from inception (id., at 22238), he did not become an officer, trustee, or director of any company in the United Founders Corporation group (id., Commission's Exhibit No. X3762) until the latter part of 1925 because, as a result of his bankruptcy, he did not want to be publicly associated as a director or officer of the company. In this respect, Mr. Bull testified (id., at 22227–8):

> Q. Mr. Bull, do you happen to know whether Mr. Coombs became an officer or director of any of these companies prior to 1927? Our records indicate that he had not.
> A. I don't think he was until about 1927. I don't recall whether it was 1926 or 1927. I don't think he was.
> Q. During the period of your activity, Mr. Coombs was neither an officer nor director of either Founders or International Securities?
> A. So far as I recall that is a correct statement.
> Q. But he was with you one of the managers whose compensation was provided for?
> A. Oh, yes; he was entirely active.
> Q. Do you know why he never became an officer?
> A. I know that we invited him to become an officer and a director, and we thought, as near as I can recall, that the reason he did not was that he had been

operating in Bridgeport, Connecticut,[14] formed Weeks, Lewis & Bull Company, a Massachusetts trust[15] and the oldest company of the United Founders Corporation group.[16] Weeks, Lewis & Bull Company, which was the predecessor of American Founders Corporation,[17] in turn sponsored International Securities Trust of America,[18] another Massachusetts trust,[19] previously "organized on paper"[20] in April 1921, as an investment trust of the general management type,[21] and as hereinafter described Weeks, Lewis & Bull Company and later its successor American Founders Corporation subsequently served as the central point for the operation and expansion of the United Founders Corporation group.

> in bankruptcy as a result of the Megargel failure and I think he felt that he wanted to clean up his affairs and perhaps get that somewhat back of him before he became publicly—well, not publicly associated—but on the board of directors, or an officer of the company. I think he always felt that although I don't know that he ever said it in just those words.

In 1925 Coombs became a trustee and member of the executive committee and in 1927 became a vice president of American Founders Trust. Thereafter he held similar office in the successor corporation and in United Founders Corporation until late in 1930 when he resigned the offices of vice president and member of executive committee, and until July 1933, when he resigned as a director of American Founders Corporation and of United Founders Corporation (id., Commission's Exhibit No. X3762) at the time of the sale of his dominant interest in United Founders Corporation to The Equity Corporation. (Commission's Report on the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and Reorganization Committees, Part VII, pp. 213–222.)

[13] Op. cit. supra, note 1, at 22016.

[14] Id., at 22221. William R. Bull, who at present is sponsoring two other investment trusts—Republl Investors Fund and Sovereign Investors (id., at 22010)—testified that in 1910 he had been a security sales man in Boston located (although not employed) in the office of C. F. Coombs & Company, and that there after in 1918 he operated as a security dealer in Bridgeport, Connecticut, under the name W. R. Bull & Company. In 1919 he incorporated W. R. Bull & Company, Inc. (id., at 22221) which in 1922 had capital resources of but about $10,000. (Id., at 22013.)

Mr. Bull served the companies of the United Founders Corporation group principally in the following capacities (id., Commission's Exhibit No. X3762):

Company	Office	Tenure of office
American Founders Corporation and its predecessor trust.	Trustee and later director	Jan. 14, 1922–Nov. 9, 1928.
	Member of Executive Committee.	Oct. 8, 1925–Nov. 17, 1928.
	President	Nov. 1, 1922–Mar. 22, 1926.
International Securities Corporation of America and its predecessor trust.	Trustee and later director	May 17, 1922–Nov. 23, 1935.
	Member of Executive Committee.	July 3, 1925–July 7, 1932.
	Chairman of the Board	May 22, 1924–Mar. 22, 1926.
	President	Mar. 22, 1926–July 7, 1932.
	Treasurer	May 1, 1923–Mar. 22, 1926.
Second International Securities Corporation.	Director	Oct. 15, 1926–Nov. 23, 1935.
	Member of Executive Committee.	Oct. 20, 1926–Sept. 21, 1927.
Founders General Corporation	Director	Feb. 21, 1928–Dec. 19, 1928.
Investment Trust Associates	Trustee	Nov. 7, 1928–July 30, 1931.

[15] Id., Commission's Exhibit No. X3427.

[16] Id., at 22011.

[17] Id., at 22016. On April 21, 1928, American Founders Corporation was incorporated in Maryland (id., Commission's Exhibit No. X3404–B [p. 1]) and on October 1, 1928, the Corporation succeeded to the business of the predecessor trust under the Plan of Transformation Into a Corporation dated August 2, 1928. (Id., Commission's Exhibits Nos. X3404–D–2, X3404–D–3.)

[18] Id., at 22015.

[19] Id., at 22016.

[20] Id., at 22011. No money was paid into International Securities Trust of America until April 1922 (Id., at 22015.)

[21] Id., Commission's Exhibit No. X3425.

In 1925 the sponsorship of the group was enlarged to include Frank B. Erwin,[22] then a securities salesman [23] but who previously had been associated with Mr. Coombs as a partner in the investment banking business of Megargel & Company [24] at the time of its failure,[25] and Louis H. Seagrave,[26] theretofore sales manager of First National Corporation of Boston, the securities affiliate of the First National Bank of Boston.[27]

Toward the end of 1928 the management of the group entered into its second phase; Mr. Bull withdrew from active participation in

[22] Id., at 22028, and Commission's Exhibit No. X3737 (pp. 6-17). Mr. Erwin served the companies of the United Founders Corporation group principally in the following capacities (id., Commission's Exhibit No. X3762):

Company	Office	Tenure of office
United Founders Corporation	Director	Feb. 1929-July 1933.
	Vice President	Feb. 1929-Oct. 1930.
	Executive Committee	Same.
American Founders Corporation and its predecessor trust.	Trustee, later director	Feb. 1925-July 1933.
	Vice president	May 1925-Oct. 1930.
	Executive Committee	Oct. 1925-Oct. 1930.
International Securities Corporation of America and its predecessor trust.	Trustee, later director	March 1925-Nov. 1930.
	Executive Committee	July 1925-July 1926.
	Vice president	May 1925-Nov. 1930.
	Treasurer	Jan. 1927-Dec. 1927.
Second International Securities Corporation	Director	Oct. 1926-Dec. 1930.
	Vice president	Same.
	Executive Committee	Oct. 1926-March 1928.
United States & British International Company, Ltd.	Director	Jan. 1928-Dec. 1930.
	Executive Committee	Jan. 1928-Sept. 1928.
Founders General Corporation	Director	Feb. 1928-Oct. 1930.
	President	Feb. 1928-Sept. 1930.
	Executive Committee	Feb. 1928-Oct. 1930.
American & General Securities Corporation	Director	Nov. 1928-Oct. 1930.
	Executive Committee	Same.
Founders Associates	Trustee	Feb. 1929-Dec. 1930.
	Vice president	Same.
	Executive Committee	Same.

[23] Id., Commission's Exhibit No. X3737 (pp. 6-10).

[24] Ibid.

[25] Ibid.; also Commission's Exhibit No. X3428.

[26] Id., at 22092-3; and Commission's Exhibit No. X3762. Mr. Seagrave was first identified with the group as a vice president of American Founders Trust in August 1925. In October 1925 Mr. Seagrave became a trustee and member of the executive committee of that company and in March 1926 succeeded Mr. Bull as president. At that time Mr. Seagrave became a trustee of International Securities Trust of America as well. From 1926 to 1935 he served without interruption as a director of every company in the group (ibid.); in addition he served the companies in the following capacities (ibid., and Commission's Exhibit No. X3762A):

Company	Office	Tenure of office
United Founders Corporation	President and Executive Committee.	Feb. 1929-Nov. 1935.
American Founders Corporation and its predecessor trust.	President	Mar. 1926-Nov. 1935.
	Executive Committee	Oct. 1925-Nov. 1935.
Second International Securities Corporation.	Vice President	Aug. 1925-Mar. 1926.
	Executive Committee	June 1935-Nov. 1935.
American & General Securities Corporation	President	June 1935-Nov. 1935.
Founders Associates	President	Feb. 1929-Nov. 1935.
	Executive Committee	Same.
American and Continental Corporation	President	July 1929-July 1932.
	Chairman of Board	Dec. 1933-Nov. 1935.
	Executive Committee	July 1929-July 1933. Dec. 1933-Nov. 1935.
General Investment Corporation (formerly Public Utility Holding Corporation of America).	Executive Committee	Sept. 1929-Dec. 1931.
United States Electric Power Corporation	Chairman of Board	Sept. 1929-Nov. 1935.
	Executive Committee	Same.

[27] Id., at 22091.

the management of American Founders Corporation.[28] Thereafter, in January 1929, Messrs. Coombs, Erwin, and Seagrave sponsored the formation of United Founders Corporation[29] through the medium of which they continued in joint control of the group until the middle of 1933.[30] At that time control of the group was disposed of to The Equity Corporation, an investment company headed by David Milton.[31] Continuity of control was maintained by The Equity Corporation until the end of 1935 when the remaining companies of the United Founders Corporation group were consolidated into American General Corporation,[32] a company presently controlled by The Equity Corporation.[33]

Chart 12 illustrates graphically the way in which control of the companies of the group was vested in United Founders Corporation directly and indirectly through the medium of American Founders Corporation at October 9, 1929.[34] (See p. 2114.)

With few exceptions the affiliations of each of the companies of the group were constant from the time of its formation until the consolidation of the remaining companies into American General Corporation in November 1935.[35] However, although United Founders Corporation held effective control of the group from 1929 to the end

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[28] Although Mr. Bull retained his directorship and presidency of International Securities Corporation of American and his directorship of Investment Trust Associates, he resigned all other positions with the group in September 1928. (See note 14, supra.)

[29] Op. cit. supra, note 1, Commission's Exhibit No. X3420 (p. 2).

[30] However Mr. Coombs and Mr. Erwin withdrew, at the end of 1930, from active participation in the management of the group. (See notes 12 and 22. supra.)

[31] Commissions Report on the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and Reorganization Committees, Part VII, pp. 212–222.

[32] On November 23, 1935, United Founders Corporation, American Founders Corporation, International Securities Corporation of America. Second International Securities Corporation, United States & British International Company, Ltd., American & General Securities Corporation, and American and Continental Corporation were consolidated with Reliance Management Corporation into American General Corporation, a Delaware corporation, pursuant to an agreement dated October 23, 1935. (Op. cit. supra, note 1, Commission's Exhibits Nos. X3404 [p. 1] and X3404–A.)

Investment Trust Associates, a subsidiary of United Founders Corporation, was liquidated in 1931. (Id., Commission's Exhibit No. X3412 [p. 1].) Founders Associates, a subsidiary of American Founders, was liquidated in 1935. (Id., Commission's Exhibit No. X3417 [p. 21].) United States and Overseas Corporation, a subsidiary of General Investment Corporation, was liquidated in 1934. (See the report on General Investment Corporation in Ch. II of this part of the report, pp. 497–623.)

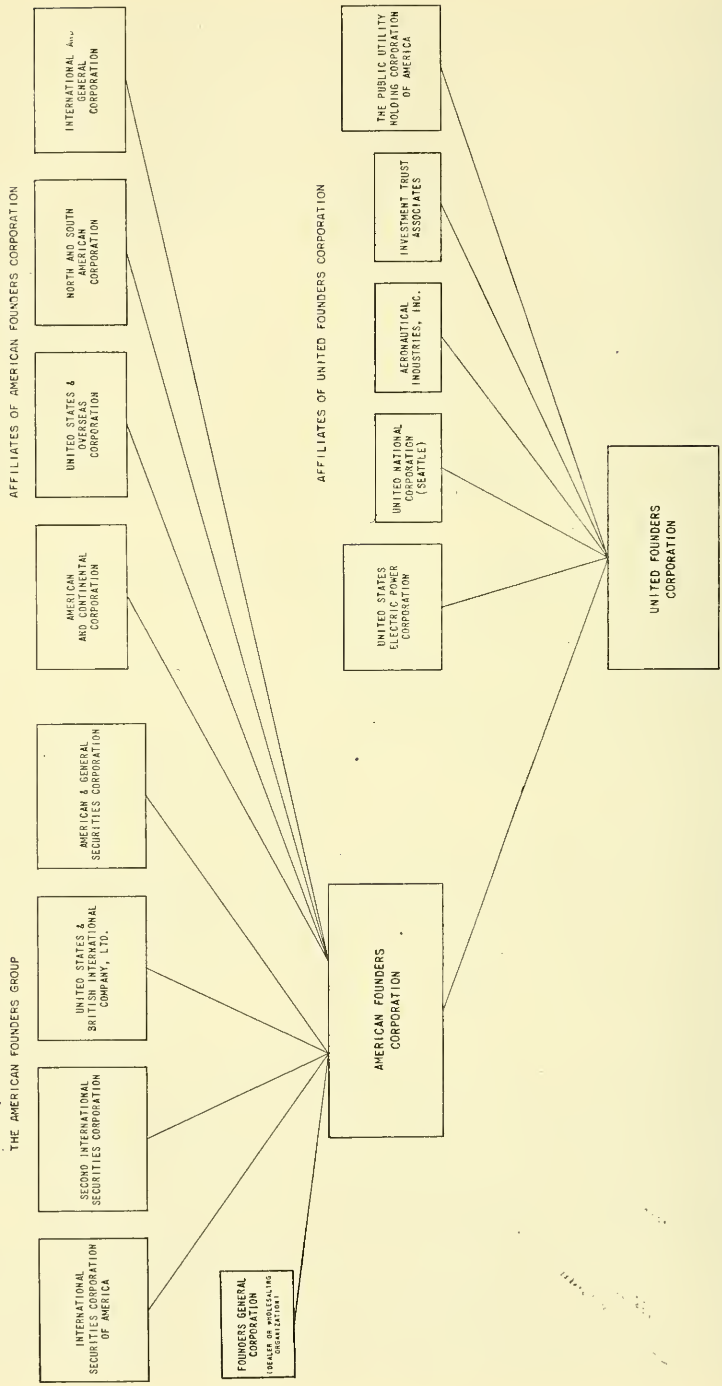
[33] Securities Registration Statement for The Equity Corporation, File No. 1–2029, filed with the Securities and Exchange Commission August 10, 1935, pursuant to the Securities Act of 1933.

[34] Op. cit. supra, note 1, Commissions Exhibit No. X3403 (p. 1). United Founders Corporation held effective control of American Founders Corporation through ownership of the largest block of common stock until February 1930, at which time United Founders Corporation acquired a majority of the common stock. (Id., Commission's Exhibit No. X3421 [p. 51].) American Founders Corporation itself did not hold a majority of voting power except momentarily in any of its investment company subsidiaries until October 1929 when it acquired the greater part of the outstanding Class A common stocks and preferred stock of International Securities Corporation of America, Second International Securities Corporation, United States & British International Co., Ltd., and American & General Securities Corporation in exchange for 1,014,972 shares of its own common stock issued for $30,449,164.50. (Id., Commission's Exhibits Nos. X3729, X3730. X3732, X3733, X3736.) With respect to control of United States Electric Power Corporation and General Investment Corporation, formerly The Public Utility Holding Corporation of America, see note 4, supra.

[35] From January 1922 until United Founders Corporation was formed in January 1929, American Founders Corporation, formerly Weeks, Lewis & Bull Company, a Massachusetts

CHART 12

RELATIONSHIPS OF THE UNITED FOUNDERS CORPORATION GROUP AND ITS AFFILIATED COMPANIES



Source: Public Examination, American General Corporation et al., Commission's Exhibit No. 13403.

of 1935, American Founders Corporation (which theretofore had been the sponsoring company of the group) continued its servicing of the group, providing investment counsel, a department to handle the purchase and sale of investments, internal auditing,[36] and both directly and later through its subsidiary, Founders General Corporation, a medium for distributing securities of the companies of the group.[37]

The performance of the 10 investment companies of the immediate United Founders Corporation group was far from successful. Of the $394,769,000 proceeds of the issuance and sale of securities to the public to the end of 1930,[38] only $41,571,000 were returned to the investors in retirement of securities and $83,000,000 were dissipated in acquisition of securities of subsidiaries at costs in excess of asset value.[39] All but approximately $50,000,000 was lost by November 23, 1935,[40] in the course of operations. The principal elements of this loss were $130,660,710.81 lost on the resale of general investments and $98,562,750.71 lost on the resale of investments in affiliates.[41]

To some extent the losses of the group were the result of a gradual break-down of the originally announced conservative principles of operation. As is discussed hereafter, the formation of each new company marked a departure from principles underlying the formation of the older companies until, by 1929, newly formed companies without restriction in their investment policy were selling securities of affiliates short, and the older companies as well as the new companies were trading stocks for profits at prices recognized by the investment manager of the group to be highly inflated. However, the losses of the group do not embrace all the losses of the public investing in the group.

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trust, served as the sponsoring company for "The American Founders Group." (Op. cit. supra, note 1, at 22101, 24466–9.)

Investment Trust Associates, from the time of its acquisition in October 1928 until late in 1929, was controlled through stock ownership by "The American Founders Group" (id., Commission's Exhibits Nos. X3780 and X3781) after which effective control was held directly by United Founders Corporation. (Id., Commission's Exhibit No. 23421 [p. 51].) In October 1930 United States & Overseas Corporation became a subsidiary of General Investment Corporation. (See the report on General Investment Corporation in Ch. II of this part of the report, pp. 497–623.)

[36] Op. cit. supra, note 1, Commission's Exhibits Nos. X4335 and X4336.

[37] Id., at 23033–5.

[38] As of November 30, 1929, these companies had issued securities for $470,080,000 proceeds, of which the public held securities having an average paid-in value of $361,020,000 and the balance was held within the group. (Id., Commission's Exhibit No. X3424C.) During 1930 United Founders Corporation raised an additional $91,457,000 of which only $4,310,000 was new capital, the remaining $87,147,000 proceeds being the result of exchange of United Founders Corporation stock for that of American Founders Corporation. (Id., Commission's Exhibit No. X3424F.) The remaining $29,439,000 of the public's $394,769,000 investment never appeared in the capital accounts of the issuing companies but instead was taken as distributing profits by the several companies of the group on the resale of each other's securities. (Id., at 22201 and Commission's Exhibit No. X3732.)

[39] Id., at 22000–11. United Founders Corporation and American Founders Corporation acquired, for cash and for securities issued in exchanges, securities of subsidiaries costing them about $188,000,000 which had a paid-in value of but $105,000,000. (Id., at 22197–22213.)

[40] Id., at 22001.

[41] See infra, pp. 2194–2219, for discussion of management of assets.

Between November 30, 1929, and November 23, 1935, the public's investment in the group, measured in terms of market price, declined from $545,181,000 [42] to $41,151,000,[43] only $41,571,000 of the $504,030,000 decline being accountable by reason of disbursements in reacquisition of securities by companies of the group.[44] Nor does the performance record of the companies indicate the extent to which the interest of the public was diluted by issue of stock to insiders at prices substantially below current asset values and the subsequent acquisition of such stock by other companies of the group at market prices far in excess of asset value. And finally the performance of the group fails to indicate the dilution of the public's investment in the group by reason of exchanges, under the persuasion of the management, of securities of one company of the group for those of another company of the group having a smaller asset value. Consequently, it is impossible to determine with any degree of exactitude the losses of the public investors. The various factors contributing to such loss will be the principal object of this summary description of the group.

B. Development of the United Founders Corporation Group

1. AMERICAN FOUNDERS CORPORATION (FORMERLY WEEKS, LEWIS & BULL COMPANY)

As previously mentioned, American Founders Corporation,[45] the oldest company of the United Founders Corporation group, was formed

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[42] Id., Commission's Exhibit No. X3424C-3.

[43] As of November 23, 1935, other than held intercompany, there were issued and outstanding securities of companies of the group having a market value of approximately $41,151,115 as follows (Securities Registration Statement for American General Corporation (withdrawn) File No. 2-2623, filed with the Securities and Exchange Commission November 11, 1936, pursuant to the Securities Act of 1933):

Company	Security	Amount	Market price	Market value
United Founders Corporation.	Common stock	15,000,000 shares	7/8	$13,125,000
American Founders Corporation.	7% preferred stock	21,593 shares	38	820,534
Do	6% preferred stock	56,263 shares	37½	2,109,863
Do	Common stock	1,402,662 shares	5/8	876,601
International Securities Corporation of America.	Secured bonds (called)	$181,000		181,000
	Debentures	$13,425,000	95	12,753,750
Do	6½% preferred stock	10,586 shares	47	497,542
Do	6% preferred stock	33,552 shares	46½	1,560,168
Do	Class A common stock	34,070 shares	7/8	29,811
Do	Class B common stock	20,846 shares	1/4	5,212
Second International Securities Corporation.	Debentures	$3,757,000	96⅛	3,611,416
Do	Preferred stock	22,307 shares	41½	925,741
Do	Class A common stock	14,329 shares	2½	35,823
Do	Class B common stock	18,479 shares	1/4	4,620
United States & British International Co., Ltd.	Debentures	$2,466,500	95¾	2,361,674
Do	Preferred stock	18,123 shares	17	308,091
Do	Class A common stock	11,240 shares	7/8	9,835
Do	Class B common stock	28,069 shares	9/16	15,789
American & General Securities Corporation.	Preferred stock	8,474 shares	47	398,278
Do	Class A common stock	11,715 shares	10	117,150
Do	Class B common stock	17,350 shares	9/16	9,759
American and Continental Corporation	Common and Class A stock	126,678 shares	11	1,393,458
Total market value				41,151,115

[44] See supra, p. 2115

[45] In order not to burden the reader unduly, Weeks, Lewis & Bull Company will be referred to as American Founders Corporation unless necessary to distinguish the corporate successor from the predecessor trust.

in 1922 as a Massachusetts trust under the name of Weeks, Lewis & Bull Company by Messrs. Coombs and Bull to serve as sponsor of International Securities Corporation of America.[46] In this respect, Mr. Bull testified:[47]

"We had two purposes in mind as between Mr. Coombs and myself. Primarily, it was to develop International Securities Trust. In order to develop an investment trust, we believed it was necessary to form a company which could do the raising of capital, the organization work, and bear the expenses, or most of the expenses. For that reason we formed Weeks, Lewis & Bull Company in Boston, and the definite purpose of Weeks, Lewis & Bull Company at that time was to go into the general security business, the same as W. R. Bull & Company, and also to distribute the shares of International Securities Trust."

However, in May 1925 the management of American Founders Corporation decided to change its character from a "semiprivately owned banking enterprise to a publicly owned institution whose shares of participation may be offered more publicly by representative investment houses and over a wider territory."[48]

Shortly thereafter, in April 1926, the management reported to the shareholders:[49]

Created primarily to serve as fiscal agent for the International Securities Trust of America and for similar investment trusts to be subsequently organized, the American Founders Trust has now become, in addition, an investment trust having a considerable portfolio of investments among its own assets * * *.

In its capacity as an investment trust the American Founders Trust may be compared with approximately 100 companies of the latter type in the United Kingdom, for the Trust is constantly investing and reinvesting its rapidly expanding capital in a wide variety of sound foreign and domestic securities.

In October 1928, American Founders Corporation, which had been incorporated in Maryland the previous April, succeeded to the business of its predecessor trust under a plan of transformation dated August 2, 1928.[50] The reason for the transformation was twofold: doing business as a Massachusetts trust inhibited national distribution of its securities[51] because certain states attached the incidents of partnership to ownership of the shares of a Massachusetts trust, as a consequence of which leading New York banking houses would not distribute the securities of Massachusetts trusts;[52] and, secondly, there was a growing feeling that "investment trust" did not describe appropriately the nature of the enterprise.[53]

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[46] For the reason stated in the preceding note, International Securities Trust of America will be referred to as International Securities Corporation of America.

[47] Op. cit. supra, note 1, at 22015.

[48] Id., Commission's Exhibit No. –3495 (p. 1).

[49] Id., Commission's Exhibit No. X3463 (p. 5).

[50] Id., Commission's Exhibits Nos. X3595 and X3596.

[51] Id., at 23012.

[52] Id., at 22082–3, 23013–4 and Commission's Exhibit No. X3605.

[53] Ibid. However, in the transformation to a corporation, the shareholders of American Founders Corporation were not informed of their right to vote on the transformation (id., at 23014–6) to a corporation but were disenfranchised by a plan which called for the irrevocable deposit of their shares together with proxies with the transformation managers. (Id., Commission's Exhibits Nos. X3595 and X3596.) While the charter and bylaws of the successor corporation accorded to the shareholders "substantially the

American Founders Corporation and its predecessor trust raised $112,446,718.30 net proceeds from the sales and resales of its capital shares.[54]

However, in spite of having raised almost $100,000,000 by the issuance of common stock alone, less than 13% of the 8,982,498 shares of common stock (or equivalent fractional scrip) issued by American Founders Corporation and its predecessor trust were issued for payments to the capital of the corporation; and less than 8% were distributed for cash. By far the vast bulk of the shares were issued to

same" rights (id., at 23018), with respect to approval of transactions in which one or more directors might have a conflicting interest, the charter reduced the necessary vote of directors from a majority of the board, all of whom had to be disinterested, to a disinterested majority of a quorum of the board (a quorum being a majority of the board) or from the vote of one more than one-half the board to the votes of one more than one-fourth the board. (Id., at 23016–8.) In a similar way the requisite vote for a gross sale of the assets of the enterprise was reduced from the affirmative votes of two-thirds of the board of directors and of the shareholders entitled to vote, to a majority vote of directors and 60% of the shareholders entitled to vote. (Id., Commission's Exhibit No. X3404.)

[54] These proceeds were raised as follows (id., Commission's Exhibits Nos. X3405 [pp. 18, 42, and 43] and X3438):

612, 287	shares First Preferred Stock	$30, 677, 470. 11
	Less:	
322, 670	First Preferred shares converted into common shares	16, 133, 500. 00
289, 617	Total, First Preferred shares	14, 543, 970. 11
8, 133	shares Second Preferred Stock	203, 325. 00
8, 982, 498	shares Common Stock	[a] 97, 829, 216. 82
	Total	112, 576, 511. 93
	Less: Commissions paid in connection with the conversion of preferred shares into common shares	936, 861. 00
	Remainder	111, 639, 650. 93
	Add: Excess of proceeds from resales of reacquired shares over cost	807, 067. 37
	Net proceeds from issue of capital shares for cost and securities and profit on sales of reacquired shares	112, 446, 718. 30

[a] This amount of $97,829,216.82 is after deduction of $4,671,919.88 which was transferred from surplus to capital in connection with the issuance of stock dividends. The 8,982,498 shares includes both shares issued as stock dividends and in split-ups. Of these 8,982,498 shares, 4,407, consisting of expired scrip certificates, were canceled.

These figures are based upon the amounts of capital outstanding on the books of American Founders Trust at October 1, 1928, the date of the transformation of the company into a corporation, plus subsequent additions. They do not include shares which were issued by the company and reacquired and retired prior to October 1, 1928.

While most of these shares were distributed by American Founders Corporation and its subsidiary, Founders General Corporation (id., Commission's Exhibit No. X3737 [pp. 92–3]) 300,000 shares of first preferred stock was distributed by The Harris Forbes Corporation in the form of 150,000 convertible allotment certificates at $100 per unit, total $15,000,000, less 6% or $900,000 commission. (Id., Commission's Exhibit No. X3708.)

the stockholders as dividends and split-ups without the receipt of any other consideration whatsoever.[55]

The organizers of American Founders Corporation contemplated a continual dilution of the proceeds received from the sale of its common stock and second preferred stock resulting from the issuance of common stock and second preferred stock to themselves for "services." The charter of the company provided:[56]

The trustees shall have power and authority and (though they shall not be obligated to do so) it is intended that they may and will distribute the second preferred and the common shares gratis to purchasers of the first preferred shares; or sell the second preferred and common shares for less than the par value thereof, or otherwise dispose of same, so that the trustees shall in no event be liable because the capital fund put in trust does not or may not include anything for the second preferred or the common shares. The trustees shall have authority and power to pay agents, underwriters, or contractors, a commission or salary for the sale of stock, and shall have power and authority to contract to pay the same either in cash or the second preferred or common stock of this company or both, but the first preferred stock shall not be sold or issued by the trustees except upon receipt by their treasurer of the par value thereof.

Pursuant to the terms of the charter, on December 28, 1923, Mr. Coombs and Mr. Bull contracted with American Founders Corporation (then a Massachusetts trust to exist only during the lifetime of designated persons) to act as its "managers" during its existence, compensation for their services to be paid by the issuance of the stock of the investment company.[57] The contract vested control of

[55] The issuance of American Founders Corporation common stock may be summarized as follows (id., Commission's Exhibits Nos. X3438 and X3405 [p. 18]):

Purpose of issue	Number of shares	Consideration received
Sold for cash	715, 285	$48, 286, 158. 32
Issued in exchange for securities of affiliates	409, 143	32, 757, 008. 50
Issued in conversion of preferred stock	194, 915	16, 134, 400. 00
Issued to managers for services	[a] 97, 955	651, 650. 00
Issued as stock dividends	822, 443	
Issued in split-ups	6, 742, 757	
Total	8, 982, 498	97, 829, 216. 83
Less scrip canceled	4, 407	
Net shares issued	8, 978, 091	

[a] This table of shares issued sets forth the number of shares as constituted at time of issue without adjustment for split-ups or stock dividends; consequently only 97,955 shares are indicated as issued to the managers for services. However, giving effect only to the split-ups by October 1927, the managers had received for services approximately 233,645 shares as adjusted for split-ups and stock dividends. (Id., at 22796–7 and Commission's Exhibit No. X4316.)

[56] Id., Commission's Exhibit No. X3427 (p. 3). On December 28, 1923 this provision was modified to the following form (id., Commission's Exhibit No. X3430 [p. 16]): "The Trustees may issue, sell and dispose of the Second Preferred Shares and of the Common Shares herein authorized, or any of them, in such manner, by way of stock dividend or otherwise, for such consideration, whether in cash, property, or services, or as a bonus to purchasers of the First Preferred Shares, at such times, and to such persons, as they shall deem advisable."

[57] Id., Commission's Exhibits Nos. X3542 and X3544. This contract which superseded retroactively a contract with Mr. Coombs, dated January 27, 1922, to which Mr. Bull was an unnamed although known

the investment company in the managers inasmuch as they were appointed the exclusive agents for the distribution of its securities and were entitled to demand issuance of its shares to themselves on credit in unlimited quantities at prices less than asset value.[58]

By October 1927, when this contract was terminated,[59] American Founders Corporation, in addition to the payment of selling expenses and commissions incidental to the distribution,[60] had issued to the managers approximately 233,645 of its common shares, as adjusted for split-ups, or in excess of 30% of the 691,482 shares of its common stock then outstanding.[61] These shares having a market value aggregating $10,240,000 at the time of their issue[62] were the principal compensation to the managers for their services in raising $62,750,000 for the group.[63]

Consequently, up to October 1927, American Founders Corporation paid (in securities) for the services of Messrs. Bull, Coombs, Erwin

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party, provided that the managers were to act as the exclusive distributing agents for the securities of American Founders Corporation and (by implication) of International Securities Corporation of America, and were to receive from American Founders Corporation, for their services and selling expenses, 4.95% of the proceeds of the distribution of the securities for cash and large blocks of common stock and second preferred stock of American Founders Corporation. Of the remuneration Mr. Coombs was to receive 55% and Mr. Bull 45%. (Id., Commission's Exhibits Nos. X3544 and X3503.) This division of the remuneration was modified, as of February 20, 1925, to include Frank B. Erwin, who had previously been associated with Mr. Coombs as a partner of Megargel & Company until its enforced liquidation in 1920 (id., Commission's Exhibit No. X3737 [p. 8]) and who, in December of 1924, became vice president and sales manager of American Founders Corporation. (Id., Commission's Exhibit No. X3737 [pp. 14 and 15].) At this time the respective shares of remuneration were changed to: Mr. Coombs, 50%; Mr. Bull, 40%; and Mr. Erwin, 10%. (Id., Commission's Exhibit No. X3547.) On November 6, 1925, the aggregate remuneration to the sponsors thereafter to be paid in terms of the aggregate proceeds of issue of securities was reduced to about one-third of the previous rate and at the same time the division between the managers was changed to: Mr. Coombs, 45%; Mr. Bull, 30%; and Mr. Erwin, 25%. (Id., Commission's Exhibit No. X3548.) In January 1926 the managers assigned 5.64% of the remuneration which they were thereafter to receive to Louis H. Seagrave (id., at 22729), the newly designated vice president of American Founders Corporation (id., Commission's Exhibit No. X3762) and in March 1926, when Seagrave became president of American Founders Corporation (ibid.) his interest was increased to 7.52%. (Id., at 22729.)

58 The contract provided the sponsors might pay for the securities one year after the date of issue. (Id., Commission's Exhibit No. X3544.) By the terms of a subsequent contract of November 6, 1925, the managers were required to pay for the securities at issuance. (Id., Commission's Exhibit No. X3548.) However, this change was without significance because, as will be discussed hereafter, American Founders Corporation loaned its managers large sums of money and such loans could and were used to buy stock of American Founders Corporation. In August 1924 Mr. Coombs and Mr. Bull assigned substantially the entire benefits of the contract to Investment Trust Associates, a common law trust created in Massachusetts for the express purpose of receiving the assignments of the contract and thereby maintaining their continuity of control of American Founders Corporation. (Id., at 22055, and Commission's Exhibits Nos. X3544 and X3503.)

59 The contract was canceled on October 19, 1927. As a consideration for cancelation, Messrs. Coombs, Bull, Erwin, and Seagrave received an option to buy 5,000 shares of American Founders Corporation common stock for $8,333.33; in addition they were each employed for 3 years under contracts at $25,000 per annum. (Id., Commission's Exhibit No. X3550.) At the time of this settlement the common stock of American Founders Corporation had a market value of $40–$42 per share (id., Commission's Exhibit No. X3773) or approximately $196,500 in excess of the option price, so that for canceling the contract and for their future services for 3 years, the 4 "managers" were to receive an aggregate of $496,500.

60 Id., Commission's Exhibits Nos. X3542, X3544, X3547, and X3548.

61 Id., at 22796–7 and Commission's Exhibit No. X4316.

62 Mr. Seagrave stated that the market value of the shares issued to the managers for services was at the time of issue equal to 13.3% of the then $77,000,000 proceeds of the issue of securities by the group. (Id., at 22732–3.)

63 Although the compensation was based on the $77,000,000 proceeds of the issuance of securities by the group (ibid.) approximately $14,250,000 of that amount had been raised

and Seagrave, the four principal executives of the group, at an average annual rate of $640,000 each.[64] It is interesting to note that prior to the organization of the investment company, Mr. Bull had conducted a modest distributing enterprise[65] and Mr. Coombs and Mr. Erwin were bankrupt,[66] and just prior to his employment by the group Mr. Seagrave had been earning $7,000 or $8,000 a year.[67]

The issuance of American Founders Corporation common stock to the managers for their services to the group diluted substantially the equity of the public which had paid $6,254,872.76 capital into American Founders Corporation for common stock.[68] Inasmuch as the investment company had no undivided profits prior to October 1927, except as the result of writing up the value of assets,[69] the issuance of 30% of its common stock[70] having a book value of $3,703,000[71] to the managers for services diluted the capital paid in by the public by 23% without offering the investors in the common stock of the company any advantage measurable in terms of earnings.

Despite the tremendous dilution of the public's investment by reason of the issuance of common shares to the managers for services, no mention of the contract or explanation of its effects was ever made to stockholders in annual reports. The only times that the contract was brought to the attention of the stockholders were at those annual meetings at which the contract or some modification thereof was approved.[72]

As heretofore indicated, the nature of American Founders Corporation changed from a management and distributing organiza-

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by the distribution of debentures of International Securities Corporation of America by Harris, Forbes & Co. (Id., Commission's Exhibit No. X3555.) The receipt of the American Founders Corporation common stock for services did not constitute the managers' sole compensation for services in connection with distribution. Although the management contract provided that the remuneration therein stated was to be the sole compensation of the managers for their services (id., Commission's Exhibits Nos. X3544, X3547, and X3548), W. R. Bull & Company, Inc., of which Mr. Bull was the sponsor and principal stockholder (id., at 22221 and 22013), received cash distributing commissions from American Founders Corporation (id., at 22226), and in addition, acting upon the guidance of the management of American Founders Corporation, was permitted from time to time to "reserve" stock of American Founders Corporation and of International Securities Corporation of America at current market prices just prior to an advance in the price of the stock by American Founders Corporation (id., at 22286–7 and Commission's Exhibit No. X3494), which made the market and established the price of both its own stock and that of International Securities Corporation of America. (Id., at 22278–83.)

[64] Mr. Coombs and Mr. Bull had worked for the group from January 1922 to October 1927, or 5 years and 9 months; Mr. Erwin was paid in stock for his services from January 1925 to October 1927, or 2 years and 9 months; and Mr. Seagrave was paid in stock for services from January 1926 to October 1927, or 1 year and 9 months. (See note 57, supra.) The total years of employment of the 4 executives was 16 years, for which they received $10,240,000 in securities, or an average of $640,000 a year each.

[65] See note 14, supra.

[66] See notes 11 and 12, supra.

[67] Op. cit. supra, note 1, at 22093.

[68] Id., Commission's Exhibit No. X3403 (pp. 3, 19, 20). This $6,254,872.76 included $807,067.37 "profit" on the resale of treasury shares.

[69] Exclusive of write-ups of assets, American Founders Corporation had sustained an $887,905.16 operating deficit (Id., Commission's Exhibit No. X3403 [p. 3]).

[70] See supra, p. 2119.

[71] Mr. Seagrave stated that the book value of the shares issued to the managers for services was at the time of issue equal to 4.81% of the $77,000,000 capital raised for the group, or about $3,703,000 (Op. cit. supra, note 1, at 22732).

[72] Id., at 23975.

tion[73] to an investment company[74] and subsequently to a holding company.[75] To its holding company activities, more than anything else, may be ascribed the tremendous losses of American Founders Corporation. Of the $112,446,718.30 capital raised by American Founders Corporation,[76] by November 23, 1935, the date of consolidation into American General Corporation,[77] $4,521,329.73 had been returned to stockholders as a result of repurchase by the Company of its own preferred shares and $6,859,533.54 cash dividends had been paid.[78] Of the balance, there remained a net worth of $17,108,892.82, indicating a net loss of $83,956,962.21.[79]

Without detailing the transactions at this point, it may be pointed out that a substantial part of the loss was the result of acquiring the investments in subsidiaries at prices far in excess of asset value.[80] As will be hereafter discussed the investments in other affiliated companies likewise involved payments of excessive prices.

2. INTERNATIONAL SECURITIES CORPORATION OF AMERICA (FORMERLY INTERNATIONAL SECURITIES TRUST OF AMERICA)

Almost immediately upon organization, American Founders Corporation undertook the contemplated sponsorship of International Securities Corporation of America.[81] International Securities Corporation of America, the first large publicly offered investment trust

[73] Id., at 22015.

[74] Id., Commission's Exhibit No. X3495 (p. 1).

[75] See note 34, supra.

[76] See note 54, supra.

[77] Op. cit. supra, note 1, Commission's Exhibits Nos. X3403 and X3405.

[78] Id., Commission's Exhibit No. X3405.

[79] American Founders Corporation sustained its operating loss as follows (Derived from op. cit. supra, note 1, Commission's Exhibit No. X3405 [pp. 21, 42, 43, 129, 130, and 131]):

Net realized and unrealized loss sustained on investments as of November 23, 1935:		
On investments in subsidiary companies	$75, 487, 217. 81	
On investments in affiliated companies	17, 510, 223. 79	
On investments in general portfolio securities	7, 148, 404. 60	
Total net loss on investments		$100, 145, 846. 20
Less: Net profit from operations (exclusive of profit or loss on securities), including $2,395,266.99 undivided profits taken over as such from American Founders Trust at the time of transformation to a corporation		16, 188, 883. 99
Net loss from operations		83, 956, 962. 21

[80] Mr. Carron, treasurer of both American Founders Corporation and United Founders Corporation testified that the 2 companies issued $105,000,000 of securities for stock of subsidiaries having a paid-in asset value of $46,000,000 less and spent $83,000,000 for stocks of subsidiaries having a paid-in asset value of $38,000,000 less (Id., at 22197–213). This established excess costs of subsidiaries totaling $83,000,000 less the proportionate share of undivided profits.

[81] Upon its organization American Founders Corporation undertook the sponsorship of International Securities Trust of America (id., at 22016 and 22830), a common law trust theretofore formed in Massachusetts in April 1921. (Id., Commission's Exhibits Nos. X3425 and X3470.) On June 1, 1927, International Securities Corporation of America was incorporated in Maryland (id., Commission's Exhibit No. X3401–B, p. 25) and on June 23, 1927, the Corporation succeeded to the business of the predecessor trust (id., Commission's Exhibit No. X3401–D–4) under a Plan of Transformation Into a Corporation, dated May 10, 1927. (Id., Commission's Exhibit No. X3401–D–1.) As a matter of convenience and to avoid confusion, unless necessary for the purpose of distinguishing the predecessor trust from its successor corporation, both will be referred to as International Securities Corporation of America.

in the United States,[82] was professedly patterned after the British investment trusts [83] from whom were adopted the idea of international diversification of investments [84] and limited investment in any one enterprise so as to minimize managerial responsibilities in underlying or portfolio companies.

International Securities Corporation of America operated as a Massachusetts common law trust until the middle of 1927,[85] when it was transformed into a corporation at the suggestion of Harris, Forbes & Co., which then distributed publicly $15,000,000 debentures for the successor corporation.[86]

In all, International Securities Corporation of America and its predecessor trust raised $64,249,322.44 net proceeds from the issuance of securities.[87]

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[82] Id., at 22025. This fact was featured in its advertising. (Ibid.)

[83] Id., at 22013 and 22025–6. This feature was also emphasized in advertising. (Ibid.)

[84] Id., at 22023–4 and 22060.

[85] See note 81, supra.

[86] Op. cit. supra, note 1, at 22830–1. One of the reasons for the transformation was that the Massachusetts trust form of enterprise was not as well known and not as well defined legally as the corporate form of enterprise. (Ibid.) As heretofore indicated, certain states regarded common law business trusts as partnerships and as a result the lending investment banking houses would not distribute the securities of common-law trusts. (Op. cit. supra, notes 51 and 52.)

[87] These proceeds were raised as follows [a] (op. cit. supra, note 1, Commission's Exhibit No. X3402 [pp. 168–178]):

5% gold debentures—par value	$31,000,000.00	
Less: Discount	2,892,500.00	
Net proceeds received		[b] $28,107,500.00
Serial gold notes		1,882,900.00
6% preferred shares—		
Proceeds from sales of 184,793 shares	[c] $18,479,793.00	
Less: Cost of 115,957 shares exchanged for common "A" shares	8,505,670.00	
		9,974,123.00
6½% preferred shares:—		
Proceeds from sales of 64,331 shares	6,552,052.89	
Less: Cost of 39,817 shares exchanged for common "A" shares	3,049,937.12	
		3,502,115.77
7% preferred shares:—		
Proceeds from sales of 876 shares	89,395.00	
Less: Cost of 49 shares exchanged for common "A" shares	5,122.00	
		84,273.00
Proceeds received from sales of 591,156 common "A" shares, including 247,297 shares issued in exchange for preferred shares	19,462,646.55	
Proceeds received from the sale of 600,000 common "B" shares	2,222,220.00	
Total		65,235,778.32
Less: Commissions paid		986,455.88
Net amount received from sales of capital securities		[d] 64,249,322.44

[a] These figures do not include shares or bonds issued and retired prior to the transformation of the trust into a corporation in June of 1927. The Serial Gold Notes were originally issued in the amount of $8,000,000 of which $6,117,000 were exchanged for preferred and common stock or repurchased for cash and retired at the time of transformation. (Op. cit. supra, note 1 at 22831 and Commission's Exhibits Nos. X3536, X3537 and X3400.)

[b] These $31,000,000 debentures were underwritten or purchased for resale by Harris, Forbes & Co. and distributed for aggregate proceeds based upon offering prices of $29,547,500.00 or a gross distributing commission of $1,440,000.00. (Id., Commission's Exhibits Nos. X3401, X3402 and X3406.)

[c] 49,458 shares of 6% preferred stock were distributed by Tucker, Anthony & Co., Ames, Emerich & Co., and Bond & Goodwin & Tucker, Inc. at $99.50 per share, (id., Commission's Exhibit No. X3401–G–8) of which $95 per share was retained net by the issuing company after the banking group had received $4.50 per share or $222,561.00 gross commissions, and Harris, Forbes & Co. had received $0.50 per share, or $24,729.00 as a finder's fee. (Id., Commission's Exhibits Nos. X3402 [pp. 171 and 178] and X3401–D 13 and D 15.) At the same time American Founders Corporation resold to Tucker, Anthony & Co. for public resale 4,684 shares International Securities Corporation of America preferred stock at $95.50 per share flat. Tucker, Anthony & Co. agreed to divide with American Founders Corporation any excess over $99.50 per share received in the sale of both the 49,458 share block of new stock and in the sale of the 4,684 share block of old stock. (Id., Commission's Exhibit No. X3616.)

[d] Except as indicated above, the securities of International Securities Corporation of America were all distributed by American Founders Corporation (id., Commission's Exhibits Nos. X3400 [pp. 11–12] and X3402 [pp. 169–175]) which, as hereafter discussed, served as fiscal agent for International Securities Corporation of America.

Although the organizers of International Securities Corporation of America contributed little if any to its initial capital,[88] they contemplated a continual dilution of the common stock issued to the public in much the same way as the dilution of the common stock of American Founders Corporation had been planned.[89] Ultimately the dilution took the form of recapitalizing International Securities Corporation of America.[90]

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[88] Mr. Bull testified that the initial capital of International Securities Corporation of America was the result of a public offering of its securities. (Op. cit. supra, note 1, at 22016.)

[89] In May 1922, American Founders Corporation received an option to buy all the common shares of International Securities Corporation of America as one of the terms of a contract in which American Founders Corporation agreed to use its best efforts to distribute the securities of International Securities Corporation of America as agent. (Id., Commission's Exhibit No. X3470.) This contract also provided that American Founders Corporation might borrow from International Securities Corporation of America against the securities issued to the former not in excess of 85% of their current market value and that American Founders Corporation would bear the expenses of the investment trust until January 1924 and that thereafter American Founders Corporation should be reimbursed, but only out of current earnings in excess of $5 per annum on the outstanding common shares of International Securities Corporation of America. (Ibid.) After an interim change in the par value of the common shares of International Securities Corporation of America from $5 per share (id., Commission's Exhibit No. X3425) to $100 per share (id., Commission's Exhibit No. X3425A) and the subsequent split-up of the shares three for one into no par common shares (id., Commission's Exhibit No. X3426) on September 28, 1923, a new contract was executed by which the sponsor, as distributing agent, was to receive, in proportion to the capital raised for International Securities Corporation of America, perpetual options to buy common shares at $33⅓ per share (the exercise of the options being subject to certain limitations as to earnings per share) or the original issue price. (Id., Commission's Exhibit No. X3471.) This modified contract also provided that American Founders Corporation might defer payment for the securities issued to it for one year from the date of delivery. There were, from time to time, additional changes in the management contracts adjusting the remuneration to American Founders Corporation for paying operating expenses of International Securities Corporation of America and adjusting for split-up of shares and restricting the extent to which options might be exercised by the sponsor in any one year. (Id., Commission's Exhibits Nos. X3473, X3474, X3476, X3478, X3479, and X3480.) In January 1926, the provision of the contract for issuing securities to American Founders Corporation on credit was rescinded. (Id., at 22714–5 and Commission's Exhibit No. X3457 [pp. 3 and 10].)

[90] Id., at 22711–3 and Commission's Exhibit No. X3426. By December 1926 American Founders Corporation had earned options to buy 643,095½ shares of International Securities Corporation common stock (as adjusted for split-ups) at $3.7037 per share and had exercised options to buy 32,557 shares for $120,581.75 which it resold at a profit of at least $529,777.02. (Id., Commission's Exhibits Nos. X3481 [p. 3] X3400 [p. 12] and X4308.) The arrangement was not satisfactory either for International Securities Corporation of America or for American Founders Corporation. (Id., at 22705.) To the former the options represented a threat of extreme dilution of the capital paid in for common stock sold to the public. (Id., at 22323.) At that time the public had bought 32,557 shares from American Founders Corporation for at least $650,358.77 (see supra) and 193,909½ shares from International Securities Corporation of America for $3,255,476.99 (id., Commission's Exhibit No. X3402 [pp. 168–78]) or in all 226,446½ shares for $3,905,835.88, an average price of $17.24 per share. The 1,610,538½ options still unexercised thus represented a potential dilution of the stock outstanding in excess of 260% and at a price about one-fifth that paid by the public. As compensation for raising $23,382,000 capital for the issuing company (id., Commission's Exhibit No. X3424–A) these options were "fantastic" (id., at 22323). American Founders Corporation was entitled to the eventual issuance of 610,538½ shares of stock at $3.7037 per share or $15,832,947 less than the current market value of $29.60 per share. (Op. cit. supra, note 1, Commission's Exhibits Nos. X4309 and X4310.) Relatively few of the options were currently exercisable. For example, at the end of 1925, of 75,000 options earned only 1,619 were exercisable. (Id., at 22322.) Consequently, to American Founders Corporation the options represented an unsalable asset (id., at 22316–7) "impractical" either for acquisition of stock so as to permit participation in earnings and control of the issuing company or for determining how profitable the sponsorship of the issuing company really was. (Id., at 22318–23.)

On December 18, 1926, the charter of International Securities Corporation was amended to reclassify the outstanding common stock as Class A common stock. In addition, the charter authorized the issuance of Class B common stock which, subject to noncumulative dividend preference of the Class A common stock and to preference of the Class A common stock in liquidation, was to receive equal earnings per share with the Class A common stock issued to the public and was entitled to merge eventually with the Class A common stock into one class of stock, share for share.[91]

The entire 600,000 shares of Class B common stock so authorized were issued to American Founders Corporation for $2,222,220 [92] in contrast to the issuance principally for public distribution of 343,859 shares of Class A common stock for $7,901,917.43.[93] As a consequence of this transaction, in addition to acquiring 45% of the voting power,[94] by this recapitalization American Founders Corporation acquired stock for $2,222,220 which had the possibility of eventually being worth almost twice the value of stock theretofore sold to the public for $7,901,917.43.

The operations of International Securities Corporation of America as a general management investment company were not successful. International Securities Corporation of America sustained a net loss of $21,161,551.22 or approximately one-third of its contributed capital.[95]

3. SECOND INTERNATIONAL SECURITIES CORPORATION OF AMERICA

The formation of Second International Securities Corporation constituted the first step in the numerical expansion of the United

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[91] Id., Commission's Exhibit No. X3426. The 600,000 shares of Class B common stock were entitled to one-third vote per share until 400,000 shares of Class A common stock were outstanding and thereafter to two-thirds vote per share until 600,000 shares of Class A common stock were outstanding, after which it was to receive a full vote per share. (Ibid.)

[92] Id., Commission's Exhibits Nos. X3481 and X3482; op. cit., supra, note 87. At the same time the options were canceled and a new management contract was executed between American Founders Corporation and International Securities Corporation of America whereby American Founders Corporation was to act as the exclusive distributing agent at a 5% commission and was to supply investment service at a fee of 4% of net income of International Securities Corporation of America. American Founders Corporation waived all claims to fees for past services. (Op. cit., supra, note 1, Commission's Exhibits Nos. X3481 and X3482.)

[93] See note 87, supra.

[94] Op. cit., supra, note 1, at 22709.

[95] These losses are calculated as follows (id., Commission's Exhibits Nos. X3402 [pp. 167–73, 177, 192, 1841] and X3400 [p. 6]):

Write-downs of investments and net loss realized on sales of investments after deducting $797,048.50 unrealized portfolio appreciation as of November 23, 1935	$30, 124, 735. 73
Less: Net earnings exclusive of profits and losses on securities and amortized bond discount and expense	6, 747, 407. 80
Undivided profits as of date of transformation	2, 350, 469. 61
Total deductions	9, 097, 877. 41
Net direct loss from operations	21, 026, 858. 32
Miscellaneous deferred expenses charged off	134, 692. 90
Loss in operation	21, 161, 551. 22

The losses sustained by International Securities Corporation of America are not comparable to any index of securities prices because the continual increase in paid-in capital until 1929, and the continual retirement of senior securities thereafter render it unfeasible to determine the average paid-in capital of the investment company.

Founders Corporation group in the course of which the management of the group departed step by step from the nature of the enterprises first sponsored by it. In this respect Mr. Seagrave testified: [96]

A. * * * There was never any thought, any reasoning, any logical progression from International [Securities Corporation of America] to a company which was a holding company. We simply plainly did one thing with one company; told the world what we intended to do with another company, and did that with the other company.

Q. Perhaps we can get the record to explain these understandings on both sides if I can propound several specific questions and you answer those concretely. The fact is as regards International, that [it] was held out to the public and advertised over and over again as a concern that invested only in seasoned securities. That is a fact?

A. That is right.

Q. The fact is it also advertised it did not indulge in promotions or underwritings. Is that correct?

A. That is correct.

Q. When it came to S. I. S. C. [Second International Securities Corporation], when it came to U. S. and B. I. [United States and British International Company, Ltd.], when it came to American and General [Securities Corporation], those restrictions were no longer applicable, and those companies dealt, bought and sold the securities of other companies in the group. That is a fact?

A. Yes; that is true. We did, to a certain extent.

* * * * * * *

Q. When we come to the question, again going back to International, it was advertised in connection with International that part of its security was that it was not connected with any banking house or house of issue, and the principle underlying stated to be that the reason for that restriction was to show that banking houses could not—that it was not connected with any banking house that might unload on it securities, as had happened sometimes in the case of the British trusts. The fact is, however, when American Founders formed certain companies they were connected with banking houses, * * * and in certain cases the banking houses did turn over the securities they held to those companies that were formed. That is a fact, isn't it?

A. That International was still the same kind of company it had been.

Q. I am not saying anything about International. I am saying that the Founders group departed from the principles that were advertised as selling arguments. That is what I am saying. I am not attempting to appraise any—to praise or blame as a result of that. I am now seeking to show there has been this progression from principles that were laid down and supposed to be in [the] case of International.

A. You insist upon calling "progression," and I don't follow you in that. We deliberately set out to do different things, and we had two different things in this group, and admitted it completely.

Q. The fact is, as I have stated before, in connection with International you had laid down as a principle applicable to International that it had no connection with any banking house, and in case of these other concerns you went out and were practically partners with banking houses, or formed some connection. That is a fact, isn't it?

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[96] Id., at 22128–30.

A. That is a fact, and they were two different types of companies, and the same kind of operation completely compatible in my opinion.

Q. But the opportunity for the bankers to turn over their securities to these companies existed, did it not?

A. Oh, yes; I suppose it existed to the extent they could influence the policies of the company. Just where in our group they did exclusively, I don't know.

Q. That is a matter we can take up later. And, generally the principle that International could not go in for the holding of a majority interest, that also was advertised from time to time as we showed from these exhibits, and that principle was departed from—well, leave out the words "departed from"—that principle was not applied in case of U. S. and B. I. or in the case of Public Utility Holding Corporation.

A. That is correct.

As will be discussed hereafter, by 1929 the management of the United Founders Corporation group had progressed to the point of conducting a group of companies primarily of a holding company nature and had invested their funds in the main without any restrictions whatsoever.

In October 1926 American Founders Corporation sponsored the incorporation of Second International Securities Corporation in Maryland.[97] According to Mr. Seagrave, who was then president of the sponsoring company,[98] Second International Securities Corporation was formed to allow for greater freedom of investment than was possible under the investment restrictions of International Securities Corporation of America [99] and to allow for expansion of the investment company business by issue of securities without International Securities Corporation of America becoming unwieldy in size.[100] However, Mr. Seagrave indicated that the securities of a newly formed company might have had sales appeal lacking in those of an older company: [101]

Q. Now there was also something, was there not, about the advantage of having the new name that might arouse new interest?

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[97] Id., Commission's Exhibit No. X3406 [p. 1].

[98] Id., Commission's Exhibit No. X3762.

[99] Id., at 22742–3. Mr. Granbery, of Harris, Forbes & Co., also testified that the growth of the group developed from too stringent investment restrictions which proved "unworkable". (Id., at 23165–6). The 3 major differences in investment restrictions were that Second International Securities Corporation could invest in unseasoned securities, participate in promotions, and could invest 15% more (in all, 25%) of its resources in securities of investment companies of the group. (Id., at 22753–4.)

[100] Id., at 22742–3. In this connection it is to be noted that in the course of the year following the formation of Second International Securities Corporation, International Securities Corporation of America increased its paid-in capital resources from $23,382,000 to $45,580,000 (ibid.), or by about $7,900,000 more than the $15,500,000 Second International Securities Corporation had raised by the end of 1927. (Id., Commission's Exhibit No. X3424–A.) By the end of 1929 International Securities Corporation of America had an aggregate of $63,725,000 paid-in capital (id., Commission's Exhibit No. X3424–C), compared with an aggregate of $22,920,000 raised by Second International Securities Corporation. (Ibid.) Apparently neither the "unworkable" investment restrictions nor the size of International Securities Corporation of America at the end of 1926 proved particularly burdensome. (Id., at 22743.) In this connection Frank B. Erwin testified (id., Commission's Exhibit No. X3737 [p. 202]) :

> As nearly as I can recall, the investment department seemed to feel that they could use the funds that were provided through the sales organization.

[101] Id., at 22744.

A. Well, I dare say that that was a consideration, yes, and there are times when the market will accept securities of a new company more readily than [those of] an old [company] and other times when it is the reverse.

Frank B. Erwin, who was in charge of the distribution of the securities of the group,[102] testified that it was in most instances easier to handle the securities of newly formed companies.[103]

Second International Securities Corporation received $22,336,922.75 net proceeds from the issuance of its securities [104] all of which, with the exception of $6,370,000 received from the sale of its debentures,[105] were purchased by or distributed publicly by American Founders Corporation [106] pursuant to a management contract executed at the time Second International Securities Corporation was organized.[107]

The acquisition of effective control of Second International Securities Corporation by American Founders Corporation involved no substantial outlay of cash.

By November 30, 1926, Second International Securities Corporation had received $6,386,660.00 proceeds from the sale of its first preferred stock, Class A common stock, and Class B common stock.[108] Of this sum, American Founders Corporation, as principal, had paid in $1,800,000 for 600,000 shares of Class B common stock,[109] thereby ac-

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[102] Id., Commission's Exhibit No. X3737 (pp. 14 and 15).

[103] Ibid. (p. 225).

[104] Capital raised through the issuance of securities by Second International Securities Corporation may be summarized as follows (id., Commission's Exhibit No. X3407 [pp. 122–8]):

5% gold debentures—	
Par value	$7,000,000.00
Discount	630,000.00
Net proceeds received	6,370,000.00
6% first preferred stock—	
Proceeds received from sale of 190,000 shares before commissions	[a] 9,514,400.00
Less: Cost of 141,063 shares exchanged for 130,091 Class "A" Common shares	4,743,025.20
	4,771,374.80
6% second preferred stock—Proceeds received from sales of 20,000 shares	1,000,000.00
Class "A" common stock—Proceeds received from sale of 308,091 shares before commissions (including 130,091 shares issued in exchange for 141,063 first preferred shares at $4,743,025.20)	9,083,025.20
Class "B" common stock—Proceeds received from sales of 600,000 shares	1,800,000.00
Total	23,024,400.00
Less: Commission on sales of capital stock	687,477.25
Net proceeds received from sales of capital securities	22,336,922.75

[a] Includes $14,400 profit realized on the resale of 20,000 reacquired first preferred shares.

[105] The $7,000,000 debenture issue was purchased by Harris, Forbes & Co. in February 1928 at 91 for resale at 95½ or $6,685,000 or a gross distributing profit of $315,000. (Id., Commission's Exhibits Nos. X3406–D1 and X3406–G3.)

[106] Id., Commission's Exhibit No. X3407 (pp. 124–6).

[107] Id., Commission's Exhibit No. X3406–E1. This contract provided that American Founders Corporation should buy the Class B common shares and the second preferred shares and should use its best efforts to distribute the remaining securities as exclusive distributing agents at a 5% distributing commission and should supply investment counsel to the company at an annual fee equal to one-half of one percent of the average resources of the investment company. (Ibid.)

[108] Id., Commission's Exhibit No. X3407 (pp. 124 and 126–7).

[109] Id., Commission's Exhibit No. X3406–R–1.

quiring effective control of Second International Securities Corporation.[110]

Almost immediately (possibly within 24 hours)[111] after American Founders Corporation had purchased the Second International Securities Corporation Class B common stock, American Founders Corporation sold to Second International Securities Corporation portfolio securities for $1,740,000.[112]

Mr. Seagrave testified that the sale to Second International Securities Corporation was made in order to provide the company with a portfolio on which earnings sufficient to meet the dividend requirements on its newly issued preferred stock would begin to accrue immediately.[113] However, Mr. Seagrave admitted that it was undesirable for a management company to sell securities from its own portfolio to that of an investment company which it managed, even for the purpose of enabling the managed company to earn its preferred dividends at the organization of the enterprise.[114]

The operation of Second International Securities Corporation was comparable to that of its older affiliated company, International Securities Corporation of America. Of the $22,336,922.75 capital raised by Second International Securities Corporation, $8,612,194.17 or a little over one-third was lost in operations.[115]

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[110] The Class B common stock of Second International Securities Corporation was entitled to voting privilege varying from one-third to one vote per share, depending upon the number of shares of Class A common stock outstanding. This voting power was so arranged that the Class B common stock was entitled to not less than one-third nor more than one-half of the combined voting power of both classes of common stock. (Id., Commission's Exhibit No. X3406-B.)

[111] Id., at 22745.

[112] This sale consisted of the following securities (id., at 22744 and Commission's Exhibits Nos. X3533, X3534, and X3535):

	Sale price
Miscellaneous foreign securities	$678,347
$600,000 International Securities Corporation of America secured bonds	549,000
4,062 shares International Securities Corporation of America, Class B common stock	406,200
4,062 shares International Securities Corporation of America, Class A common stock	105,612

[113] Id., at 22745-6.

[114] Id., at 22745-52. In this connection it should be noted that American Founders Corporation was to receive a 5% selling commission on the proceeds of the newly issued securities of International Securities Corporation of America (id., Commission's Exhbits Nos. X3481 and X3482), and that on the sale of 400 of the International Securities Corporation of America Class A common shares American Founders Corporation recorded a $10,000 profit. (Id., Commission's Exhibit No. X4308.)

[115] Id., Commission's Exhibits Nos. X3405 (p. 145) and X3407 (pp. 6, 122, 124, 128-9).

Based upon the market value of investments, there remained a net worth in Second International Securities of $7,248,524.82 as of November 23, 1935, applicable to the outstanding debentures and various classes of capital stock. The shrinkage of the $22,336,922.75 contributed capital to $7,248,524.82 net worth is accounted for as follows (ibid.):

Contributed capital		$22,336,922.75	
Less: Cost to company of bonds and preferred shares purchased for retirement		2,883,885.93	
Net capital paid in after retirements			$19,453,036.82
Less: Loss from operations:			
Net realized and unrealized losses on investments	$11,521,573.14		
Miscellaneous charges	22,703.90		
Total	11,544,277.04		
Net earnings exclusive of profits and losses on investments	2,932,082.87		
Net loss from operations	8,612,194.17		
Cash dividends paid	3,592,317.83		
Total deductions from net paid in capital			12,204,512.00
Net worth at November 23, 1935			7,248,524.82

4. UNITED STATES & BRITISH INTERNATIONAL COMPANY, LTD.

In January 1928 United States & British International Company, Ltd., the fourth investment company of the United Founders Corporation group,[116] was incorporated in Maryland.[117] As in the formation of Second International Securities Corporation, the formation of United States & British International Company, Ltd., involved departure from principles governing the older companies of the group. Although prior to the organization of United States & British International Company, Ltd., the companies of the United Founders Corporation group had been advertised as independent of investment banker affiliations,[118] four investment banking houses participated with American Founders Corporation in the sponsorship (although not in the management) of United States & British International Company, Ltd.[119]

Mr. Seagrave testified:

A. As I was explaining, the idea behind this company had been that the management of British and American companies could be brought together. When we got into it, we concluded that it would not be a very feasible arrangement, on account of the distance, and yet we did want to carry on this plan. We thought we might gain a good deal from it, and the final plan that was evolved was that a subsidiary company to be known as Trans-Oceanic Trust, Ltd., would be formed, and a good part of its stock owned by U. S. & British, and in that way we would get in that company and in our investment in it the benefit of their direct supervision, through contact the benefit of indirect assistance, and they, in turn, would get, they hoped, something from us.[120]

Q. * * * Now, with the formation of Second International [Securities Corporation] and again in the formation of U. S. & British, you departed from the principle that had likewise governed and was advertised to govern International Securities Trust up to this time, namely, that these companies could invest in new enterprises. They were not restricted as International

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[116] In April and May 1927 American Founders Corporation caused to be incorporated in New York State a wholly owned subsidiary, American Founders Office Building, Inc., to acquire and hold title to the premises, 50 Pine Street, New York City, at a cost of $625,000. This subsidiary was held by American Founders Corporation until November 23, 1935. (Id., Commission's Exhibits Nos. X3404–E [pp. 14–22] and X3556.)

[117] Id., Commission's Exhibit No. X3408–B (p. 19).

[118] Id., at 22063 and Commission's Exhibit No. X3509. In this respect, Mr. Bull testified (id., at 22064):

> Q. And the reason for advertising no connection with such houses, I suggest, was perhaps that it had been the experience of British trusts that some of them have been connected with houses of issue and that houses of issue had issued their own securities and used the trust as a means of getting rid of some of their securities which otherwise might be, shall we say, hard stocks?
> A. That was an abuse from time to time, I know in England and in the United States.
> Q. Then the purpose of this argument was to show that International Securities Trust was free of this difficulty, that there was no house that could unload its securities on International?
> A. I think that is correct; yes, sir.

[119] Id., at 22078–81. These firms were Pogue-Willard & Company, Inc. (an investment banking house in New York), Helbert Wagg & Co., Ltd. (a British house), Ames, Emerich & Co., Tucker, Anthony & Co., and Harris, Forbes & Co. (Ibid.)

[120] Transoceanic Trust, Ltd., was formed in England (id., Commission's Exhibit No. X3630) as an investment company of the general management type. (Id., Commission's

was under its charter to seasoned securities, securities that had a certain number of years' existence?

A. That is true. We did make that departure but it was a deliberate one, an intended deviation from the restrictions which prevented International Securities Trust from doing so.

Q. Don't assume from these questions, Mr. Seagrave, that I am implying any criticism. I am just developing the facts.

A. Yes.

Q. The fact is that you started off with International and advertised that it had certain principles and restrictions; one of them was that it could not go in for promotions or underwritings; another one was that it could not invest in securities except such as were seasoned, and the third was that it was not connected with any house or issue. Now, up to this point in 1928 these principles have been laid aside in the case of these operating companies.

A. That is correct.

United States & British International Co., Ltd., received $16,525,-500 net proceeds from the issuance of its securities.[121]

Exhibit No. X3408–F–1 [p. 5].) During the period of its joint control by United States & British International Co., Ltd., and Helbert Wagg & Co., Ltd., Transoceanic Trust, Ltd., was managed by the latter sponsor under a contract calling, except for the first year when the annual fee was ½ of 1% even, for annual fee of ¾ of 1% of the first £500,000 capital and ½ of 1% on the remaining capital resources. (Id., Commission's Exhibits Nos. X3631 and X3632.) In order to further control by Helbert Wagg & Co., Ltd., United States & British International Co., Ltd., delivered to Helbert Wagg & Co., Ltd., a proxy for 7 years on the stock of Transoceanic Trust, Ltd., that United States & British International Co., Ltd., held. (Id. Commission's Exhibit No. X3634.) Transoceanic Trust, Ltd., received in all paid-in capital of £1,017,500 (about $5,000,000) for £1,000,000 par stock. Of this, there was issued in January 1928, £500,000 par at 1¾% premium for £508,750. Except for qualifying shares of directors, the entire issue (49,743 of the 50,000 shares) was purchased by United States & British International Co., Ltd., for $2,453,502.27 (Id., Commission's Exhibits Nos. X3633 and X3634.)

In August 1928 Transoceanic Trust, Ltd., issued an additional 50,000 shares of capital stock (£500,000 par) at a 1¾% premium for £508,750. (Ibid.) This issue was distributed in England by Helbert Wagg & Co., Ltd., by installment sales. (Id., Commission's Exhibit No. X3635.) On November 1, 1928, the 100,000 shares of capital stock, £10 par value, was split up into 100,000 shares 5% cumulative preferred, £6 par value, and 100,000 shares ordinary, £4 par value. (Id., Commission's Exhibit No. X3633.) United States & British International Co., Ltd., ultimately disposed of its $2,453,502.27 investment in Transoceanic Trust, Ltd., to English interests in 1933 at a loss of $1,086,532.75. (Id., Commission's Exhibit No. X3409 [pp. 87, 88, and 95].)

[121] The securities of United States & British International Co., Ltd., were issued as follows (id., Commission's Exhibit No. X3409 [p. 6]):

$6,000,000 5% debentures less discount of $570,000.00	[a] $5,430,000.00
$3 Preferred shares—	
Proceeds received from sales of 140,000 shares	[b] 7,000,000.00
Less: Cost of 90,940 shares exchanged for 119,358 Common "A" shares	3,024,307.62
	3,975,692.38
Class "A" Common shares—	
Proceeds received from sales of 294,358 shares, including 119,358 shares issued in exchange for 90,940 $3 preferred shares at $3,024,307.62	[c] 6,219,807.62
Class "B" Common shares—	
Proceeds received from sale of 300,000 shares	[d] 1,000,000.00
Net proceeds received from sales of all capital securities	16,625,500.00

[a] The $6,000,000 debentures were underwritten by Harris, Forbes & Co. in May 1928 at 90½ or $5,430,000 for resale at 95, a gross distributing profit $270,000. (Op. cit. supra, note 1, Commission's Exhibit No. X3628.)

[b] The 140,000 shares of preferred stock, together with 140,000 shares of Class A common stock were purchased in February 1928 by Tucker, Anthony & Co. and Pogue-Willard & Co. as syndicate managers for $9,212,000, and were distributed publicly by them and Ames, Emerich & Co., Inc. at $70 per unit or $9,800,000, for a gross profit of $588,000. (Id., Commission's Exhibits Nos. X3409 [p. 96] and X3408–G.)

[c] At inception, United States & British International Co., Ltd. issued to a distributing syndicate 140,000 shares of Class A common stock in units for $2,212,000 and 5,000 shares to American Founders Corporation for $83,500; (ibid.) in the last quarter of 1928 United States & British International Co., Ltd., issued 30,000 Class A common shares to American Founders Corporation for $900,000 (ibid., and

Effective voting control of United States & British International Co., Ltd., was vested in the sponsors through their acquisition of its Class B common stock [122] which enjoyed a voting power varying from 33⅓% to 50% of the total voting power.[123]

Although American Founders Corporation invested initially in United States & British International Co., Ltd., only $583,500 and acquired thereby only about one-half the 300,000-share issue of Class B common stock and a small block of Class A common stock,[124] American Founders Corporation dominated the sponsorship of its newly formed $10,300,000 affiliate.[125] This domination was accomplished by sales restrictions agreements covering 89,232 of the remaining 150,000 shares of Class B common stock executed by the remaining sponsors and their associates [126] and by the terms of a management company executed between it and its newly formed affiliate.[127]

The performance of United States & British International Co., Ltd., was even more unsuccessful than that of its affiliated companies. By November 23, 1935, United States & British International Co.,

Commission's Exhibits Nos. X3629 and X3810). In addition to the 175,000 shares issued for $3,195,500 cash, in February 1930, United States & British International Co., Ltd., issued 119,358 shares of Class A common stock to American Founders Corporation in exchange for 90,940 shares of preferred stock which it retired. (Id., Commission's Exhibit No. X3409 [p. 96].)

[d] The 300,000 shares Class B stock were issued as follows (id., Commission's Exhibit No. X4314):

Purchaser	Shares	Amount
American Founders Corporation	165, 000	$550, 000. 00
Pogue-Willard & Co	104, 979	349, 930. 00
Helbert Wagg & Co	30, 000	100, 000. 00
Various directors	21	70. 00
	300, 000	1, 000, 000. 00

[122] See note 121, supra.

[123] Op. cit. supra, note 1, Commission's Exhibit No. X3408–B (pp. 5 and 12).

[124] See note 121, supra. However, as part of the plan of organization, United States & British International Co., Ltd., invested $2,500,000 of the $10,800,000 initial capital in buying at current market prices portfolio securities from American Founders Corporation. (Op. cit. supra, note 1, at 23036 and 24009.) According to Mr. Seagrave, these sales were made to permit United States & British International Co., Ltd., to invest its funds so as to immediately begin earning current preferred dividend requirements. (Id., at 23041.)

[125] See note 121, supra.

[126] Op. cit. supra, note 1, Commission's Exhibit No. X3650. In October 1928 and July 1929 American Founders Corporation purchased from United States & British International Co., Ltd., its co-sponsors, 42,000 shares of the Class B common stock for $682,500 (id., Commission's Exhibit No. X3930), thereby affording the co-sponsors a profit of $542,500 beyond their cost of $3⅓ per share. (See note 121, supra.)

[127] At about the time of organization United States & British International Co., Ltd., executed a contract with American Founders Corporation appointing the latter its fiscal agent and investment counsel. For the services to be rendered American Founders Corporation was to be compensated annually with ½ of 1% of aggregate average resources, exclusive of investments in Transoceanic Trust, Ltd. (Op. cit. supra, note 1, Commission's Exhibit No. X3408–A–1.)

Ltd., had lost in operations $9,263,095.59 or 55% of the $16,625,000 capital paid into it.[128]

5. FOUNDERS GENERAL CORPORATION

Founders General Corporation was incorporated in Maryland in February 1928 [129] as a wholly-owned subsidiary of American Founders Corporation [130] to handle the distribution of the securities of the group.[131] According to Mr. Erwin: "* * * It seemed the business of distributing of securities and the marketing of securities [conducted by American Founders Corporation] had grown to a larger proportion than had ever been anticipated" and out of "character" [132] with an investment "institution." [133] Moreover, it was felt that there might be some legal objection to American Founders Corporation trading in its own securities.[134]

The management of American Founders Corporation, having sought without success to secure suitable independent sponsorship for the distribution of the common stocks of the United Founders Corporation group,[135] thought that by the specious device of transferring the distributing activities from American Founders Corporation to a wholly-owned subsidiary company, the "character" of the parent would be "preserved," although the activity of the distribution conducted by the subsidiary might expand to an unparalleled extent.[136] In this

[128] The shrinkage of United States & British International Co., Ltd., was as follows (id., Commission's Exhibits Nos. X3409 [pp. 6, 93, 96] and X4131–F–84):

Cost of $3,514,000 par value debentures repurchased and retired	$2,011,104.76	
Cost of 20,000 $3 Preferred Shares repurchased and retired	814,000.00	
Total Cost of Securities Repurchased	2,825,104.76	
Cash dividends paid	1,103,939.98	
Total cost of repurchases and cash dividends paid		$3,929,044.74
Write-downs of investments and net loss realized on sales of investments, less $106,240.36 unrealized portfolio appreciation at November 23, 1935	$10,199,563.30	
Net earnings exclusive of profit and losses on investments and amortized bond discount	954,507.23	
Net operating loss	9,245,056.07	
Miscellaneous charges	18,039.52	
Total losses on operations		9,263,095.59
Total decrease of net paid-in capital		13,192,140.33

[129] Op cit., supra, note 1, at 22085 and 23007, and Commission's Exhibit No. X3590–A.

[130] Id., at 22084–5 and 23033–4.

[131] Id., Commission's Exhibit No. X3737 (p. 173).

[132] Id., Commission's Exhibit No. X3737 (pp. 175–6).

[133] Id., at 22084–5.

[134] Id., Commission's Exhibit No. X3737 (p. 174).

[135] Id., at 22084–5 and 23033–4.

[136] Founders General Corporation ultimately had approximately 300 officers and employees. (Id., at 22151.) During 1929 Founders General Corporation sold to dealers securities of affiliates for approximately $400,000,000 and purchased from dealers securities of affiliates for approximately $221,000,000. In 1930 sales dropped to $76,900,000 compared to purchases of $91,400,000. (Id., Commission's Exhibit No. X3580.) The distributing activity of Founders General Corporation was discontinued early in 1931 (id., Commission's Exhibit No. X4183), when Founders General Corporation transferred its options to buy United Founders Corporation common stock, received in connection with distributing activities, to Allied General Corporation. (Id., Commission's Exhibit No. X4482.)

respect, Royal E. T. Riggs, counsel for the United Founders Corporation, testified:[137]

Q. So that the situation that developed was that American Founders found that an unduly large part of its activities was involved in distribution and the desire to preserve its character as an investment company and as a management company and therefore it took out the distributing activities and put it down into Founders General, is that correct?

A. I should say that would cover it. That is about the size of it. You see, as more and more stock had been issued, there had been more and more activity in the stock and more deals.

In all, Founders General Corporation received $7,575,000 capital paid to it for the issuance of its securities as follows:[138]

80,000 shares $3.50 cumul. div. pref. stock	$3, 975, 000
10,000 shares Class A Stock	50, 000
50,000 shares Class B stock	3, 550, 000
Total	$7, 575, 000

All of the stock was sold to American Founders Corporation [139] except the Class A (voting) shares which were purchased by Messrs. Coombs, Bull, Erwin, and Seagrave [140] who simultaneously gave to American Founders Corporation irrevocable options to purchase the shares from them.[141] It was intended in this way to overcome restrictions which might be imposed upon the ownership of subsidiaries by investment companies as a result of prospective legislation. At the time Founders General Corporation was organized, a bill which required the consent of the New York Superintendent of Banks to the ownership of subsidiaries by investment trusts [142] was pending before the New York State Legislature sponsored, among others, by Louis H. Seagrave and Royal E. T. Riggs of the United Founders Corporation group.[143] Although Mr. Riggs approved and sponsored legislative restriction of the ownership of subsidiaries by investment trusts, he devised a means of avoiding the prospective restriction insofar as it applied to American Founders Corporation by having the principal officers of American Founders Corporation hold title to the voting stock of Founders General Corporation.[144]

While empowered to do a general distributing business,[145] the activity of Founders General Corporation was limited almost exclusively to

[137] Id., Commission's Exhibit No. X3737 (pp. 175–6).

[138] Id., Commission's Exhibit No. X3415 (p. 41).

[139] Ibid.

[140] Id., Commission's Exhibits Nos. X3591 and X3592.

[141] Id., at 24120 and Commission's Exhibits Nos. X3591 and X3592. After the bill pending before the New York State Legislature was defeated in August 1929, American Founders Corporation exercised its options and acquired the Class A shares. (Id., Commission's Exhibit No. X3593.)

[142] Id., at 24118–20.

[143] Id., at 24021–2. Others sponsoring the legislation were Leonard Wallstein, representing a group of fixed trusts, and Edward B. Twombley, representing the Insuranshares Corporation group of investment companies. (Ibid.)

[144] Id., at 24122 and Commission's Exhibit No. X3593.

[145] Id., Commission's Exhibit No. X3590–A.

distributing and trading in the securities of the companies of the United Founders Corporation group.[146]

In this respect, Frank B. Erwin, president of Founders General Corporation, testified:[147]

> Q. The purpose of Founders General was to distribute the securities of the companies in the Founders group.
>
> A. And any other they might see fit to do.
>
> Q. But it was primarily distribution and whatever trading was done was trading in support of the distribution.
>
> A. I should say that that——
>
> Q. Plus the problem of balancing your market itself and distributing securities so the market would not be ragged.
>
> A. Correct.

The success of Founders General Corporation is not measurable primarily by the profits which it recorded. During the years 1928–1930, inclusive, Founders General Corporation played the leading role in the distribution of the securities by the companies of the group. In the course of these activities Founders General Corporation turned over its capital forty-two times in the open market by purchasing $322,000,000 of securities of affiliates.

However, for the period from February 1928 until November 23, 1935, Founders General Corporation with a maximum capitalization of $7,575,000 showed a gross profit of $7,276,231.77 and a net operating profit of $2,108,079.99.[148] All of these profits were obtained from distributing or trading in the securities of its affiliated companies.

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[146] For example, during the period from February to December 1928, Founders General Corporation sold to dealers securities of affiliates for approximately $10,190,000 and purchased in the market securities of affiliates for approximately $10,165,000, the total transactions in securities other than those of affiliates being limited to an aggregate of $11,665.86. (Id., Commission's Exhibit X3580.) From these transactions Founders General Corporation realized $238,262.46 profits. (Id., Commission's Exhibit No. X3582.) Until November 1, 1928, Founders General Corporation was really inactive, and Mr. Riggs testified (id., at 2412):

> The purchases and sales up to November 1, 1928, were made on the market with dealers and their customers by American Founders Trust, but they were for the account of Founders General Corporation.

[147] Id., Commission's Exhibit No. X3737 (pp. 176–7).

[148] As of November 23, 1935 there remained a net worth in Founders General Corporation of $49,294.56 as compared to the original capital contribution of $7,575,000. This shrinkage was a result of the following (id., Commission's Exhibit No. X3415, p. 41):

Contributed capital		$7,575,000.00
Net realized and unrealized profit on securities	$7,276,231.77	
Less: Net loss on operations, exclusive of profit and loss on securities	5,168,151.78	
Net operating profit		2,108,079.99
Total		9,683,079.99
Less:		
Cost to company of capital shares repurchased for retirement	$2,690,550.00	
Cash dividends paid	6,443,235.43	
Disbursements in settlement of suit of Ericson, et al	500,000.00	
		9,633,785.43
Net worth, November 23, 1935		49,294.56

6. AMERICAN & GENERAL SECURITIES CORPORATION

In October 1928 American Founders Corporation sponsored the incorporation of American & General Securities Corporation in Maryland.[149] The reasons for the addition of this company to the group are not quite clear. Mr. Seagrave testified that the management of American Founders Corporation had begun to entertain doubts with respect to the wisdom of certain of the investment restrictions both of International Securities Corporation of America and of Second International Securities Corporation,[150] particularly with respect to limitations on promotional activities, participation in underwritings and investments in new enterprises.[151] In addition, the management also felt that no one investment company of the group should be permitted to expand to too large a size.[152] However, the investment restrictions adopted by American & General Securities Corporation were almost identical with those of Second International Securities Corporation.[153]

American & General Securities Corporation received $17,000,000 net proceeds from the issuance and sale of its securities.[154]

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149 Op. cit. supra, note 1, Commission's Exhibit No. X3410–B2. American Founders Corporation subscribed for all the stock issued by American & General Securities Corporation. (Id., Commission's Exhibit No. X3410–D1–4.)

150 Id., at 22953–9.

151 Id., at 22081.

152 Ibid.

153 Id., Commission's Exhibits Nos. X3410–C (pp. 7–10) and X3406–C (pp. 7–10). Both companies were limited in their investments in new enterprises and in promotions to 20% of their resources. The only substantial difference was that Second International Securities Corporation was required to own at least 400 different investments whereas American & General Securities Corporation was required to own only 200 different securities. (Ibid.) According to Mr. Seagrave, this permitted American & General Securities Corporation to concentrate its investments in securities of affiliates. (Id., at 22960.)

154 American & General Securities Corporation issued its securities as follows (id., Commission's Exhibit No. X3411 [p. 64]):

$3 preferred stock—	
Proceeds from sale of 200,000 shares	$10, 000, 000. 00
Less: Cost of 156,098 shares subsequently exchanged for 200,000 Class "A" common shares	5, 655, 508. 58
	4, 344, 491. 42
Class "A" common shares—	
Proceeds received from sales of 500,000 shares, including 200,000 shares issued in exchange for 156,098 preferred shares at $5,655,508.58	11, 655, 508. 58
Class "B" common shares—	
Proceeds received from sale of 500,000 shares	1, 000, 000. 00
Net proceeds received from sales of capital securities	17, 000, 000. 00

NOTE.—All of these stocks were purchased by the older companies of the United Founders Corporation group (ibid.) and they in turn realized $374,172.03 profits on the redistribution of part of the stock acquired through a syndicate to their own stockholders and others. The principal offering, which was made by a syndicate headed by American Founders Corporation (id., at 22082), consisted of the 200,000 shares of preferred stock and 200,000 shares of Class A common stock acquired at an aggregate cost of $14,000,000 and offered in the form of 200,000 allotment certificates first to the stockholders of the various companies of the group and then to the public (id., at 22082 and 22097 and Commission's Exhibit No. X3647) at $74 per unit, or $12,800,000, a gross profit of $800,000 (id., at 22082 and Commission's Exhibits Nos. X3410–B 1–3 and X3410–G2), of which the companies of the group received $208,012.03. (Id., Commission's Exhibits Nos. X3648 and X3951.) In addition to the $208,012.03 profits recorded by the group on the distribution of the American & General

Control of American & General Securities Corporation vested in American Founders Corporation by virtue of the Class B common stock which was entitled to 62½% of the combined voting power of both classes of common stock[155] although the $1,000,000 paid in therefor represented less than 6% of the total capital paid in.

The operations of American & General Securities Corporation were no more successful than its older affiliated companies. Of the $17,000,000 paid-in capital, by November 23, 1935 an aggregate of $7,563,098.12 or about 44% was lost in operations.[156]

7. INVESTMENT TRUST ASSOCIATES

At approximately the same time that it sponsored the formation of American & General Securities Corporation, American Founders Corporation also acquired the name and charter of Investment Trust Associates, the Massachusetts common-law trust organized in 1924 by Mr. Coombs and Mr. Bull to perpetuate their control of American

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Securities Corporation allotment certificates, $99,000 profit was realized on the immediate resale to the public of 9,900 shares of Class A common stock (id., Commission's Exhibits Nos. X3410–B–3, X3410–D [pp. 2–3] and X3770) and $67,160.00 on the immediate resale of 19,685 of the 500,000 shares of Class B common stock which it had purchased. (Id., Commission's Exhibit No. X3880.)

[155] Each of the 300,000 shares of Class A common stock and of the 500,000 shares Class B common stock were entitled to one vote per share. (Id., Commission's Exhibit No. X3410–B.) American Founders Corporation, which purchased the 500,000 shares of Class B common stock, alloted 125,000 shares to affiliated companies and 54,800 shares to officers and directors of the group, as follows (id., Commission's Exhibit No. X3411):

Investment Trust Associates	100, 000 shares
Founders General Corporation	25, 000 shares
Mr. Seagrave	12, 500 shares
Mr. Coombs	12, 500 shares
Mr. Erwin	12, 500 shares
E. Stanley Glines	2, 100 shares
G. E. Devendorf	1, 100 shares
E. Rankin	1, 100 shares
Other officers and directors	5, 000 shares

American Founders Corporation itself retained over one-half the Class B shares at all times. (Id., Commission's Exhibit No. X3405.) The 100,000 shares of American & General Securities Corporation Class A common stock not tied up in allotment certificates was purchased by American Founders Corporation and alloted in part to affiliated companies, officers, and The Harris Forbes Corporation, as follows (id., Commission's Exhibits Nos. X3411 and X3770):

Second International Securities Corporation	4, 900 shares
United States & British International Co., Ltd	5, 000 shares
Investment Trust Associates	25, 000 shares
The Harris Forbes Corporation	8, 000 shares
Various officers and directors of the group	6, 450 shares

[156] The shrinkage of American & General Securities Corporation from $17,000,000 to $6,234,780.77 is accountable as follows (id., Commission's Exhibits Nos. X3405 [p. 144] and X3411 [pp. 6, 63–6, and 81]):

Cost of 35,392 $3 preferred shares repurchased and retired	$1, 313, 169. 91
Payment of cash dividends	1, 888, 951. 20
Total returned to investors	3, 202, 121. 11
Write-down of investments and net loss realized on sales of investments less unrealized portfolio appreciation as of November 23, 1935	9, 623, 326. 69
Less: Net earnings exclusive of profit and loss on investments and after deducting $64,664.05 sundry charges	2, 060, 228. 57
Net operating loss	7, 563, 098. 12
Capital shrinkage	10, 765, 219. 23

Founders Corporation,[157] In the latter part of 1928 Mr. Coombs, who had acquired the exclusive ownership of Investment Trust Associates,[158] decided to abandon the use of Investment Trust Associates, and American Founders Corporation, inspired by the attractive name for distribution of securities to the public and the four years' existence of the trust,[159] offered to take over the trust if all its liabilities were discharged and its net assets distributed in retirement of the outstanding shares.[160] This offer was accepted.[161]

Although only the "shell" of the enterprise devoid of all assets was acquired,[162] the acquisition of Investment Trust Associates by American Founders Corporation served two purposes:

(a) Because Investment Trust Associates was four years old, according to Mr. Seagrave,[163] it "technically complied" with the investment restrictions of International Securities Corporation of America limiting it to investments in seasoned securities; Investment Trust Associates thus provided a medium for International Securities Corporation of America to profit from investments in its affiliates; and

(b) Investment Trust Associates provided the medium for the United Founders Corporation group to secure a greater profit on the redistribution to the public of each other's securities placed in the "shell" called "Investment Trust Associates." The device employed was to sell such securities to Investment Trust Associates at market and then to sell to the public the stock of Investment Trust Associates received in payment at a profit and at a price higher than the market value of the underlying portfolio sold to Investment Trust Associates.

This latter purpose warrants elaboration. Investment Trust Associates issued 600,000 shares of common stock for $13,000,000.[164] Of this, 340,000 shares were issued in November 1928 to affiliated companies

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[157] See note 58, supra. The plan of perpetuating control called for Mr. Coombs and Mr. Bull to assign to Investment Trust Associates, for which they were the sole trustees, the common stock of American Founders Corporation, which they were to receive for their services as managers (an amount equal to about 30% of all the common shares issued to the end of 1927). In the event of the disability or death of either Mr. Coombs or Mr. Bull, the survivor would continue in joint control of Investment Trust Associates with alternate trustees designated by the incapacitated trustee. (Op. cit., supra, note 1, Commission's Exhibits Nos. X3544 and X3503.) In November 1925 the assignment to Investment Trust Associates was canceled. (Id., Commission's Exhibit No. X3548.)

[158] In 1925 Mr. Coombs acquired the exclusive interest in Investment Trust Associates (id., at 22094), because in March 1925 Investment Trust Associates had subordinated its assignment from Mr. Bull to an agreement between Mr. Bull and American Founders Corporation, whereby Mr. Bull pledged with American Founders Corporation the shares theretofore assigned to Investment Trust Associates and shares thereafter to be received for services in order to secure $300,000 loans to Mr. Bull and enterprises in which he was interested. (Id., Commission's Exhibit No. X3491.)

[159] Id., at 22095–7, 22967, and 22974.

[160] Id., Commission's' Exhibits Nos. X3640 and X3642. American Founders Corporation offered to acquire, subject to the stated conditions, 100 shares at $10 per share. (Ibid.)

[161] Ibid. The assets and liabilities of Investment Trust Associates were transferred to Investors' General Corporation, a personal holding company of the Coombs family. (Id., at 22495 and 22967.)

[162] Id., at 22096.

[163] Id., at 22974. The validity of this assertion is questionable since the stock of Investment Trust Associates was not a "seasoned security" (id., at 23151) as was required by the investment restrictions of International Securities Corporation of America. (Id., at 22128–30 and Commission's Exhibit No. X3401.)

[164] Id., Commission's Exhibit No. X3821.

at $10 per share.[165] Of the $3,400,000 capital received, $3,337,000 was immediately invested in securities of the companies of the United Founders Corporation group[166] purchased from the affiliated companies.[167]

Almost immediately, the affiliated companies which had acquired the 340,000 shares of Investment Trust Associates common stock disposed of 70,646 shares of Investment Trust Associates stock to the public for a profit of $913,780, or 129%.[168]

At first, the control of Investment Trust Associates was maintained in the system through the holdings of the various companies managed by American Founders Corporation since American Founders Corporation divested itself of the ownership of any of the shares shortly after Investment Trust Associates was acquired by American Founders Corporation.[169] In August 1929 control of Investment Trust Associates was acquired by United Founders Corporation directly through the purchase of most of the stock previously held by the other companies of the group.[170] This control of Investment Trust Associates was maintained in the United Founders Corporation group until liquidation of Investment Trust Associates in the middle of 1931.

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[165] These 340,000 shares were issued as follows (ibid.):

American Founders Corporation	95,000 shares
International Securities Corporation of America	140,000 shares
Second International Securities Corporation	65,000 shares
United States & British International Co., Ltd	40,000 shares

In January and February 1929 Investment Trust Associates issued 60,000 shares of its stock at $10 per share as follows (ibid.):

American & General Securities Corporation	25,000 shares
International Securities Corporation of America	25,000 shares
United States & British International Co., Ltd	10,000 shares

In August 1929, 200,000 shares were issued at $45 per share pursuant to the exercise of rights currently distributed to the holders of its 400,000 shares. (Id., Commission's Exhibit No. X3412–C3.)

[166] Id., Commission's Exhibit No. X3643.

[167] Id., Commission's Exhibit No. X3732C. These sales were made at discounts from current market prices and involved a slight profit to the sellers. (Ibid.) One of the consequences of the investment of the $3,337,000 in the securities of affiliates was to give International Securities Corporation of America, which, as just indicated, acquired 140,000 of the 340,000 shares initially issued (see note 165, supra), approximately a 40% interest in $1,156,000 of securities ineligible for direct investment by International Securities Corporation of America (op. cit. supra, note 1, Commission's Exhibit No. X3643) since the investment restrictions of International Securities Corporation of America forbade investments in securities of companies less than four years old. (Id., at 22973 and 22753–4 and Commission's Exhibit No. X3401 [p. 7].)

[168] Id., Commission's Exhibit No. X3848. The total profit realized on resale to the public within 9 months was as follows (id., Commission's Exhibit Nos. X3780 and X3781):

Company	Shares sold	Profit
American Founders Corporation	82,050	$27,250.00
American & General Securities Corp	10,800	442,120.25
International Securities Corporation of America	42,846	535,780.00
Second International Securities Corporation	15,000	250,000.00
United States & British International Co., Ltd	10,000	100,000.00
Total	160,696	1,355,150.25

[169] Id., Commission's Exhibit No. X3780.

[170] Ibid.

The operations of Investment Trust Associates, considering the brief period of operation and that it was liquidated before the depth of depression was reached, was no more successful than that of its affiliates. Between October 1928 and June 30, 1931, Investment Trust Associates had lost in operations $5,083,368.87, or about 39% of the $13,000,000 paid-in capital.[171] Unlike any of the other subsidiary investment companies in the group, Investment Trust Associates invested its capital principally in securities of affiliated companies.[172]

8. FOUNDERS ASSOCIATES

On February 4, 1929, American Founders Corporation sponsored the formation of Founders Associates, a Massachusetts common-law trust,[173] for the following three purposes: (a) to give the officers and employees of the companies of the United Founders Corporation group an opportunity to acquire through the purchase of Founders Associates stock an interest in securities of the group to be held by Founders Associates; [174] (b) to provide a profit-sharing plan for the officers and employees of the companies of the United Founders Corporation group [175] in lieu of paying them larger salaries; [176] and (c) to provide for the officers and employees of the companies of the group, who might purchase an interest in Founders Associates, leverage in their investment therein through the subscription by the companies of the United Founders Corporation group to preferred stock issued by Founders Associates.[177] To accomplish these purposes the management of the group caused to be issued or sold to Founders Associates securities of the companies of the group at a discount aggregating $52,000 from the prevailing market and provided the opportunity for Founders Associates to participate in the formation of new companies of the United Founders Corporation group.[178] Apparently Founders

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[171] The shrinkage of Investment Trust Associates from $13,000,000 paid-in capital to $7,106,976.13 net worth by June 1931 may be summarized as follows (id., Commission's Exhibit No. X3413 [pp. 9 and 21–2]) :

Cash dividends paid and accrued	$780,000.00
Net operating loss, including realized and unrealized losses on investments amounting to $5,321,326.74	5,083,368.87
Expenses of merger	29,655.00
Total shrinkage	5,893,023.87

[172] At the end of the fiscal years such investments constituted from 50% to 100% of the paid-in capital as follows (id., Commission's Exhibit No. X3413 [pp. 19 and 20]) :

Date	Paid-in capital	Aggregate of investments in securities of affiliates
November 30, 1928	$3,400,000	$3,344,000
November 30, 1929	13,000,000	6,386,000
November 30, 1930	13,000,000	7,840,000
June 30, 1931	13,000,000	7,869,000

[173] Id., Commission's Exhibit No. X3417–D.

[174] Id., at 24144.

[175] Ibid. and Commission's Exhibit No. X3658.

[176] Id., at 22099.

[177] Ibid.

[178] Id., at 24150 and Commission's Exhibit No. X3662.

Associates was intended largely as a means of benefiting senior members of the management of the group. First, the stock was nonvoting, control vesting in the senior officers of the group as trustees.[179] Second, the terms of subscription of the employees of the group varied depending upon whether they were senior or junior employees.[180] Third, the senior officers were permitted to subscribe for a very substantial part of the common stock, although the companies of the group themselves were called upon to furnish the major part of the funds of the Founders Associates.

Founders Associates received $577,755 for the issuance and sale of its securities.[181] However, 30% of its common stock was issued to six of the senior officers of the group for $60,000 and approximately 55% of the common stock was issued to seventeen officers (including those six officers) for $109,000.[182] Since the initial portfolio acquired by Founders Associates was purchased at prices prevailing in November and December 1928,[183] and at a price $52,000 less than the current market value,[184] the 17 officers, all of whom by the terms of their subscription agreement were privileged to tender the stock to American Founders Corporation at a price equal to current liquidating value, received an immediate value of $28,600 in excess of the cost to them.[185] Because the companies of the United Founders Corporation group were supplying the preferred stock capital to Founders Associates, the senior officers of the group, who had the control of Founders Associates, as well as the largest interest in its common stock, were in effect trading in the securities of the group in part with funds supplied by companies of the group. These senior officers could (and, in fact some of them did)

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[179] Control of Founders Associates vested in the secretary and treasurer of American Founders Corporation and the active presidents of the affiliated companies who were designated trustees of Founders Associates. (Id., Commission's Exhibit No. X3417–D.)

[180] There were two Founders Associates stock subscription agreements dated February 7, 1929, one of which was applicable to the subscriptions of senior employees and officers, and the other to the subscription of junior employees. These subscription agreements differed in that the senior employees and officers were privileged to tender their shares to American Founders Corporation at their current liquidating asset value, whereas the junior employees might sell their shares only with the permission of the executive committee of the American Founders Corporation. (Id. at 24145–9 and Commission's Exhibits Nos. X3417 [pp. 16 and 27], X3417–7 and X3417–D.)

[181] Founders Associates issued the following securities (id., Commission's Exhibit No. X3417 [pp. 15 and 16]):

7,200 shares of $50 par preferred stock	$360, 000. 00
39,668 shares common stock	217, 755. 00

The preferred stock was purchased by American Founders Corporation on behalf of the companies of the United Founders Corporation group as follows (ibid.):

American Founders Corporation	2, 160 shares
Second International Securities Corporation	1, 656 shares
United States & British International Co., Ltd	1, 224 shares
American & General Securities Corporation	1, 224 shares
Founders General Corporation	648 shares
Investment Trust Associates	288 shares

International Securities Corporation of America, at the time of the organization of Founders Associates, had investment restrictions which forbade it to invest in securities of companies less than 4 years old. (Id., Commission's Exhibit No. X3401.)

The common shares were issued: 3,000 shares to affiliated companies and 36,368 shares to officers and employees of the companies of the group. (Id., Commission's Exhibit No. X3417–G.)

[182] Id., at 24150–1 and Commission's Exhibit No. X3417 (pp. 37–8).

[183] Id., at 24150.

[184] Ibid.

[185] Id., at 24151.

terminate their interest by tendering their holdings of the common stock of Founders Associates to American Founders Corporation at its liquidating value.[186]

The $577,755 capital raised by Founders Associates was largely invested and reinvested in the companies of the United Founders Corporation group.

In the course of its operations from February 1929 to November 15, 1935, when it was liquidated,[187] Founders Associates lost $277,590.46, or 48% of its paid-in capital,[188] largely on transactions in securities of the remaining companies of the group.[189]

9. UNITED FOUNDERS CORPORATION

United Founders Corporation was incorporated in Maryland in February 1929[190] in order to perpetuate the control by Messrs. Coombs, Erwin and Seagrave of American Founders Corporation and the investment companies sponsored by American Founders Corporation.[191] In this respect Mr. Seagrave testified:[192]

Q. Now we come to the formation of United Founders. I wish you would tell us, Mr. Seagrave, why United Founders was formed. * * *

A. The concern of the directors and those connected with the company in one way or another had been growing for sometime past that it might develop that someone would acquire a sufficient interest in American Founders Cor-

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[186] Information relative to the final disposition of the 21,800 shares sold to 17 senior officers of the group at $5 per share is available with respect to 9 officers. By December 31, 1930, 5 of these 9 had sold their total holdings consisting of 5,200 shares, or about 24% of the total of 21,800 shares to Founders General Corporation for an aggregate amount of $107,352.00 or a profit of $81,352 on an investment of $26,000. The remaining 4 officers reporting to the Commission retained their 6,750 shares, or approximately 31% of the 21,800 shares, until a later date, mostly until liquidation of Founders Associates in 1935, and sustained a loss of $26,451.52 on an investment of $33,750. (Id., Commission's Exhibits Nos. X3417 [pp. 37–8 and 47–8], X3936, X3948, X4318, and X4323.)

[187] In the liquidation the $174,178.75 remaining assets were distributed as follows (id., Commission's Exhibit No. X3417 [pp. 10, 17, and 21]): 21,933 shares of United Founders common stock, having a current market value of $20,562.19 were distributed to the officers and employees of the United Founders Corporation group still holding Founders Associates common stock, and the remaining assets, consisting of $153,616.56 cash and 14,000 shares of General Investment Corporation common stock valued at $3 for the block, were distributed to United Founders Corporation and American Founders Corporation on their holdings of 3,096 preferred shares and 24,289 common shares.

[188] The shrinkage of Founders Associates is accountable as follows (id., Commission's Exhibit No. X3417 [pp. 6, 10, and 15–9]):

Cost of preferred and common capital shares repurchased and retired	$71,985.79
Cash dividends paid	54,000.00
Total returned to investors	125,985.79
Write-down of investments and net unrealized depreciation in portfolio at Nov. 15, 1935, less net profit realized on sales of investments	238,028.81
Net operating loss exclusive of profits and losses on investments	39,561.65
Net operating loss	277,590.46
Total capital decrease	403,576.25

[189] Id., Commission's Exhibit No. X3417–B, Schedule 4.

[190] Id., Commission's Exhibit No. X3420–B.

[191] Messrs. Coombs, Erwin, and Seagrave already dominated the group through ownership of about 11% of the 1,584,911 outstanding shares of American Founders Corporation common stock, all of which had previously been issued to them for services. (Id., at 22102–3 and Commission's Exhibit No. X3405 [p. 18].)

For details of issuance to the managers for services, see supra, Sec. B–1.

[192] Op. cit. supra, note 1, at 22101.

poration at that time to eventually upset the management. The concern of some of the directors was often expressed to me and the concern of Harris Forbes, which had sponsored some of the securities publicly and United Founders was really the outgrowth of the study over about a year's time, so far as I was concerned of what could be done to remedy that situation.

And finally we decided to form the company which should have a voting stock that would give reasonable assurance that it would not be bought by someone else, and which [company] would have, however, some additional interest. It would be a holding company, not a management company, and in general that was the background. We considered other alternatives, voting trusts and what not, but this seemed to be the best solution. It had to be financed, one of the objectives being to acquire a sufficient holding of American Founders Corporation to protect it [American Founders Corporation] against the loss of control to some other group. * * *

To perpetuate control of the group, the authorized capitalization of United Founders Corporation included in addition to 5,000,000 shares of common stock (entitled to one vote per share) 1,000,000 shares of Class A common stock entitled at all times to 33⅓% of the combined voting power of the outstanding shares of both classes and entitled to participate in earnings and on liquidation in proportion that the capital paid in therefore bore to the entire paid-in capital.[193] These 1,000,000 shares of Class A stock were issued in equal thirds to Messrs. Coombs, Erwin and Seagrave at $1 per share in exchange for 12,500 shares of American Founders Corporation common stock.[194] However, the shares of American Founders Corporation surrendered in the exchange had cost the three sponsors only their services to the group for a brief part of the time from 1922 until 1927.[195] The three Class A stockholders then entered into a voting agreement which provided that they would vote the shares of United Founders Corporation common and Class A stocks held by them en bloc, and that no one of them would sell his United Founders Corporation Class A stock without first offering it to the other two.[196]

Messrs. Coombs, Erwin and Seagrave held control of the United Founders Corporation group until July 1933. At that time David H. Milton and Ellory C. Huntington through The Equity Corporation, another investment company which they dominated, acquired control of United Founders Corporation and consequently of the group, by purchasing the United Founders Corporation Class A and common shares held by Mr. Coombs and Mr. Erwin. A voting trust

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[193] Id., Commission's Exhibit No. X3420–B (pp. 7 and 8). In July 1929, the charter was amended to authorize an additional 10,000,000 common shares. (Ibid.)

[194] Id., Commission's Exhibits, Nos. X3691 and X3420–D–1. The effective control thus acquired by Messrs. Coombs, Erwin, and Seagrave was increased by their acquisition of 1,575,937 of the 2,400,000 shares of common stock initially issued by United Founders Corporation (see infra, note 197) as follows:

946,627 shares acquired by Bond and Share Investment Company, Ltd., and Provident Investing Co., Ltd. (op. cit. supra, note 1, Commission's Exhibit No. X3668), two personal holding companies of the Coombs family. (Id., at 22484.)

452,535 shares acquired by Frank B. Erwin and his family. (Id., Commission's Exhibit No. X3676.)

176,775 shares acquired by Louis H. Seagrave and Clara Seagrave. (Id., Commission's Exhibits Nos. X3668 and X3676.)

[195] At this time the three sponsors held in excess of 160,000 shares of American Founders Corporation common stock, all of which had been issued to them for services for the years 1922 to 1927. (See note 191, supra.)

[196] Op cit. supra, note 1, Commission's Exhibit No. X3420–H–5.

agreement was then entered into with Louis H. Seagrave respecting his shares of United Founders Corporation Class A stock.[197] The Equity Corporation maintained control of the United Founders Corporation until its consolidation into American General Corporation on November 23, 1935, and has continued in control of the new company thereafter.[198]

United Founders Corporation ultimately received net paid-in capital of $300,866,000.90 consisting of the $1,000,000 paid for the Class A common stock and $299,866,000.90 paid for 15,000,000 shares of common stock.[199]

Consequently the management secured to themselves effective control through purchasing the Class A common stock for 1/3 of 1% of the paid-in capital.

No less startling is the tremendous load borne by the shares which were issued to the public. The entire 8,448,168 common shares were issued at an average price of $34.84 per share for an aggregate $294,-393,524.70 paid-in capital between February 1929 and the end of November 1931; 2,400,000 or over 28% of the shares were issued to the organizers and their associates for $24,302,531.50 or about 8.1% of the capital paid in, and 6,048,168 or less than 72% of the shares were issued to the public for $270,090,993.28, or about 91.9% of the

[197] See the Commission's Report on the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and Reorganization Committees, Part VII, pp. 212–22.

[198] Ibid. and see notes 30, 31, 32, and 33, supra.

[199] Op. cit. supra, note 1, Commission's Exhibit No. X3421 (pp. 39, 40, 41, and 44). The common shares were issued as follows (ibid. [pp. 39, 40, and 44]):

	Shares	Proceeds
Issued at organization at $10 per share to officers and directors of the group in exchange for American Founders Corporation common stock at $80 per share and Class B stocks of affiliates at various prices	1, 794, 937	$17, 949, 370. 00
Issued at organization at $10.50 per share cash to officers, The Harris Forbes Corporation and the affiliated companies of the group	[a] 605, 063	6, 353, 161. 50
Issued from March to November 1929 for cash at prices from $25.60 to $63.39 per share principally to Founders General Corporation for public distribution	2, 600, 000	126. 294. 941. 28
Issued in July and August 1929 at $52.50 per share to public in exchange for 500,000 shares of American Founders Corporation common stock	1, 000, 000	52, 500, 000. 00
Issued during fiscal year 1930 for cash at various prices to Founders General Corporation for public distribution	120, 000	4, 310, 000. 00
Issued in March and April 1930 at $39 per share to public in exchange for 3,351,790 53/70 shares of American Founders Corporation common stock (after split up)	2, 234, 527 12/70	87, 146, 559. 65
Issued during fiscal year 1931 for cash at $8.50 per share to Founders General Corporation for public distribution	125, 000	1, 062, 500. 00
Issued in September 1935 at $1.02 per share to The Equity Corporation in exchange for securities of subsidiaries of United Founders Corporation	5, 999, 844	6, 124, 791. 97
Total	[b] 14, 479, 371 12/70	301, 741, 324. 40
Less: Commissions paid in connection with the distribution of certain of these shares of $1,830,323.50 and sundry expenses of $45,000.00		1,875, 323. 50
Net amount paid in on common shares		299, 866, 000. 90

[a] At organization, United Founders Corporation purchased from certain companies and individuals closely identified with its organizers to whom it had issued 249,063 shares of common stock for $2,615,161.50 cash, securities of companies of the group for $2,665,500.00. (Op. cit. supra, note 1, Commission's Exhibits Nos. X3421 [p. 39] and X3670.)

[b] In addition United Founders Corporation issued 554,467 36/70 shares of common stock capitalized at $5,444,675.14 as stock dividends.

capital paid in.[200] In other words, the organizers distributed to the public 6,048,168 shares of newly issued stock having an average paid-in value (after issuance) of $34.84 per share or $210,728,173.12 for net proceeds to the company of $270,090,993.28 as a result of which the 2,400,000 shares which the organizers had initially issued to themselves and their associates increased in paid-in value from the cost price of $24,302,531.50 to the average paid-in value of $34.84 per share or $83,665,351.66.

The United Founders Corporation suffered losses more severe than any of the nine other investment companies of the group herein discussed. Of the $300,866,000 capital paid into the company[201] by November 23, 1935, a total of $285,443,277.42 had been lost in operations, leaving in November 1935 but $15,348,371.58 remaining assets.[202] Of the $15,348,371.58 asset value over $4,000,000 represented an increment of asset value resulting from the retirement of senior securities by its subsidiaries at discounts from their asset value.[203] Since the company had received $6,124,791.97 additional capital in September 1935[204] its losses in operation constituted approximately 96.8% of the $294,741,208 capital utilized in operations. By far the greatest part of the loss was sustained through holding company operations,[205] and, as previously indicated, were in part due to the acquisition of control of subsidiaries both directly and through the medium of American Founders Corporation at prices vastly in excess of asset value.[206]

10. AMERICAN AND CONTINENTAL CORPORATION

American and Continental Corporation, which became one of the United Founders Corporation group in July 1929, was incorporated in Delaware in October 1924,[207] and was, until July 1929, operated as an incorporated "syndicate"[208] effecting intermediate credits to

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[200] Op. cit. supra, note 1, Commission's Exhibit No. X3421.

[201] See note 199, supra.

[202] These losses were as follows (op. cit. supra, note 1, Commission's Exhibits Nos. X3424–J and X3421 [p. 48]):

Value placed upon distribution of property dividend	$74, 351. 00
Net loss on investments in subsidiary and affiliated companies, including write-downs, profits, and losses realized on sales, and unrealized depreciation at November 23, 1935	263, 793, 512. 31
Net losses on general portfolio securities, including profits and losses realized on sales and unrealized depreciation at November 23, 1935	25, 883, 071. 76
Net loss on investments	289, 676, 584. 07
Less: Net income exclusive of profits and losses on investments	4, 233, 306. 65
Net operating loss	285, 443, 277. 42
Capital shrinkage	285, 517, 628. 42

[203] See note 280, infra.

[204] See note 199, supra.

[205] See note 202, supra.

[206] See note 199, supra.

[207] Op. cit. supra, note 1, Commission's Exhibit No. X3418–D.

[208] Id., Commission's Exhibit No. X4246 (pp. 4–10). In contrast with that of the usual corporation, the stock of American and Continental Corporation could not be transferred freely. The Class B shares, which possessed the exclusive voting power, by the terms of the charter could not be sold without notice to the issuing company, which was privileged to reacquire the shares at book value. (Id., Commission's Exhibit No. X3718–D [p. 10].) The Class A shares were only 20% paid for (id., Commission's Exhibit No. X3419 [p. 51]) and, consequently, the consent of the issuing company was necessary if the seller was to be relieved of liability on the subscription.

European borrowers [209] under the sponsorship of International Acceptance Bank, Inc.,[210] Kuhn Loeb & Co.; Dillon, Read & Co.; [211] and The North American Company [212] and under the active management of a correspondent group of German banks and investment bankers.[213]

At the time American Founders Corporation acquired its interest in American and Continental Corporation, the latter company had received $9,956,250, net proceeds from the issuance of its securities.[214]

In July 1929, American Founders Corporation purchased a major interest in American and Continental Corporation for $12,958,100. This included $4,958,100 representing the purchase price paid the sponsors for the 100,000 Class A shares (on which 20%, or $2,000,000

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[209] According to James Warburg (id., Commission's Exhibit No. X4246 [pp. 4–6], American and Continental Corporation was formed as the result of an hiatus that developed after the World War between bank credit and long term funded debt credit available to German and other Continental European borrowers. International Acceptance Bank, Inc., through its European banking connections, felt a tremendous demand for longer term credits than the six months or one year credits that banks would supply to German and other Continental European borrowers who were not sufficiently important or not sufficiently recovered from the war to sell public issues.

[210] The International Acceptance Bank, Inc., which had been originally sponsored by Paul Warburg, a partner of Kuhn, Loeb & Co.; Mr. Wing, of the First National Bank of Boston; and Stone & Webster, an investment banking company in New York, together with a group of foreign banking interests, was subsequently acquired early in 1929 by the president and directors of The Manhattan Company, popularly known as "Bank of Manhattan", through an exchange of stock. (Id., Commission's Exhibit No. X4246 [p. 37].) The Bank of Manhattan itself had been organized under a special charter granted by the legislature of the State of New York in 1799. Until 1929 the president and directors of The Manhattan Company were engaged in the banking business. At the time of the acquisition of International Acceptance Bank, Inc. (and its subsidiary, International Acceptance Trust Company) all of the active banking operations and all of the assets of the president and directors of The Manhattan Company other than the stock of subsidiaries, were transferred to the International Acceptance Trust Company, the name of which was changed to the Bank of Manhattan Trust Company, and an additional subsidiary to engage in investment banking, International Manhattan Company was formed. Later in 1932 the president and directors of The Manhattan Company resumed its banking business as the result of the liquidation of the International Acceptance Bank, Inc., and the merger with it of its other subsidiary, the Bank of Manhattan Trust Company. The president and directors of The Manhattan Company continued as the holding company of International Manhattan Company until the end of 1937, when that company was liquidated, leaving only the original banking company in active business. (Id., Commission's Exhibit No. X4246 [pp. 64–51.)

[211] In order to permit it to operate without embarrassment a company to compete in business with American and Continental Corporation, in January 1926 Dillon, Read & Co. withdrew in favor of W. A. Harriman & Co., Inc. (Id., Commission's Exhibit No. X4246 [p. 9].)

[212] Id., Commission's Exhibit No. X3740.

[213] Id., Commission's Exhibit No. X3741. This group consisted of Deutsche Bank and Discontogesellschafft, Berlin; M. M. Warburg & Company, Hamburg; and A. Levy, Sol Oppenheim & Company, and J. H. Stein, in Cologne. (Ibid.) The correspondent group, in addition to serving as managers, took risk participations in the loans. (Ibid.) To permit closer cooperation between the correspondent group and American and Continental Corporation, at the end of 1925 Industrial Finance and Investment Company, Ltd., a subsidiary company, was formed, jointly owned by American and Continental Corporation and the correspondent group. (Id., Commission's Exhibit No. X3742.)

[214] American and Continental Corporation had issued the following securities (id., Commission's Exhibit No. X3419 [pp. 48 and 51–2]):

Security:	*Proceeds*
$7,500,000 debentures [a]	$7,143,750
100,000 shares Class A stock (20% paid for) [b]	2,000,000
32,500 shares Class B stock [c]	812,500
Total	9,956,250

[a] This issue was purchased in March 1928 by Kuhn, Loeb & Co. at a net price of 95¼ to American and Continental Corporation and were distributed to the public by a syndicate composed of: Kuhn, Loeb & Co., A. G. Becker & Co., Field, Glore &

had been paid) and 16,251 of the 32,500 Class B shares, and $8,000,000, representing the 80% unpaid balance on the 100,000 Class A shares, was paid into the company.[215] The $4,958,100 paid by American Founders Corporation to the sponsors of American and Continental Corporation was $1,793,000, or about 40%, in excess of the liquidating value of the stocks acquired[216] and was made at a time when to the

Company, W. A. Harriman & Co., Inc., and International Acceptance Bank. (Id., Commission's Exhibits Nos. X3745, X3746, and X3418–G1.)

[b] The Class A shares were issued to the sponsors and retransferred to their business associates (id., Commission's Exhibit No. X4246 [pp. 9–12]) as follows (id. Commission's Exhibits Nos. X3740, X3743, and X3744):

Purchaser	Number of shares	Seller
1924		
International Acceptance Bank	25,000	American and Continental Corporation.
Kuhn, Loeb & Co	25,000	
Dillon, Read & Co	25,000	
North American Company	25,000	
United States & Foreign Securities Corporation	25,000	Dillon, Read & Co.
Kuhn, Loeb & Co	5,000	United States & Foreign Securities Corporation.
Cosmopolis Securities Corporation, a family corporation of the Warburgs (id., Commission's Exhibit No. X4246 at p. 15).	5,000	
A. G. Becker & Co	5,000	
Cosmopolis Securities Corporation	6,000	Kuhn, Loeb & Co.
International Acceptance Bank	4,000	
Farmers Loan & Trust Co	5,000	International Acceptance Bank.
Marshall Field Glore Ward & Co	5,000	
N. Y. Trust Co	2,500	
American International Corp	2,500	
First National Corporation of Boston	2,500	
Stone & Webster, Inc	2,500	
Societe Financiere de Transports et d'enterprises Industrielles, Brussels.	3,000	
Hope & Co., Amsterdam	1,000	
Aktiebolaget Svenska, Handelsbanken, Stockholm	500	
Skandinaviska Kreditaktiebolaget, Stockholm	500	
1926		
W. A. Harriman & Company	10,000	U. S. & Foreign Securities Corp.
First Securities Corporation of Los Angeles	1,000	W. A. Harriman & Co., Inc.

[c] The Class B shares were issued and retransferred as follows (id., Commission's Exhibits Nos. X3740, X3743, and X3744):

Purchaser	Number of shares	Seller
1924		
International Acceptance Bank	10,000	American and Continental Corporation.
Kuhn, Loeb & Co	7,500	
Dillon, Read & Co	7,500	
North American Company	7,500	
United States & Foreign Securities Corporation	7,500	Dillon, Read & Co.
Kuhn, Loeb & Co	1,500	United States & Foreign Securities Corporation.
Cosmopolis Securities Corporation	1,500	
A. G. Becker & Co	1,500	
1926		
W. A. Harriman & Co., Inc	3,000	
First Securities Corporation of Los Angeles	250	W. A. Harriman & Co., Inc.

[215] Op cit. supra, note 1, Commission's Exhibits Nos. X3723 and X3726.

[216] By the terms of the purchase agreement, the 100,000 shares of Class A stock and 32,500 shares of Class B stock of American and Continental Corporation were reclassified into

knowledge of American Founders Corporation the foreign credit business of American and Continental Corporation was becoming less attractive.[217]

Nevertheless, not only was the major stock interest in the company purchased from the sponsors, but a subscription for stock was assumed and paid, thereby relieving the unwilling predecessor interests of the necessity of meeting their obligation. In this respect Mr. Seagrave testified.[218]

Q. * * * you stated to us that Mr. Warburg pointed out at that conference, or one of those conferences that the competition for German intermediate credits had increased substantially and that the interest rates had been reduced substantially.

A. I think that is generally true, though Mr. Warburg's views were chiefly of what he was apprehensive about rather than what had actually occurred up to that time.

Q. And you pointed out that he also stated that his shareholders in American and Continental were not particularly desirous of paying in that $8,000,000 subscription. Whether they were in the funds or not they just weren't entirely too keen on paying that.

A. Well, I think that is true, but the reason why they were not keen on paying it was because they had been interested in forming a company to deal in inter-

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425,000 shares of common stock and 25,000 shares of Class A common stock (differing from the common stock only in that as a class it was entitled to 33⅓% voting power) of which American Founders Corporation received 375,000 shares of common stock and 16,251 shares of Class A common stock. (Id., Commission's Exhibits Nos. X3723 and X3756.) At the time there were $12,914,816.27 net assets applicable to all the stock, or about $18.70 per share; about $11,121,000 of this was applicable to the 387,501 shares acquired by American Founders Corporation at a cost of $12,958,100. (Id., Commission's Exhibits Nos. X3752 and X3752–A.)

[217] Id., Commission's Exhibit No. X4246 (p. 31). Mr. Seagrave testified that when American Founders Corporation acquired its interest in American and Continental Corporation foreign interest rates had fallen because of competition among lenders as a result of which it was contemplated to devote approximately one-half the resources of American and Continental Corporation to general investment operations. (Id., at 26507–9.)

Although the operations of American and Continental Corporation from 1924 until the middle of 1929 were, on the whole, profitable and by May 31, 1929, had resulted in approximately $2,150,000 undivided profits and unrealized capital gains (id., Commission's Exhibits Nos. X3752 and X3752–A) the successful operations were largely the result of discrepancies between the domestic and the German interest rate. The success of American and Continental Corporation was probably due in no small part to its ability to borrow money on time from the large metropolitan banks on the basis of the $8,000,000 subscriptions receivable from its Class A stockholders and re-lend the funds abroad at higher interest rates. (Id., Commission's Exhibit No. X4246 [p. 6].) For example, at times when American and Continental Corporation was lending money abroad at 12% per annum, it was paying but 4¾% per annum on domestic loans made to it. (Id., Commission's Exhibit No. X3742.) Successful operations were also in a measure due to American and Continental Corporation's obtaining as one of the terms of the loans options to buy common stock of the borrowers from which substantial profits were realized. (Id., Commission's Exhibits Nos. X3749 and X3750.) However, in 1928 the interest rates on domestic time deposits had increased to a point at which American and Continental Corporation could not borrow profitably domestic money for foreign lending operations, the return from which had fallen off conversely as the result of competition among lenders; thereupon $7,500,000 debentures were issued to provide capital for American and Continental Corporation's further operation. (Ibid. [pp. 17–18] and Commission's Exhibit No. X3748.)

The result of this changing trend in conditions of operation was immediately felt; as reported to American Founders Corporation, the gross income of American and Continental Corporation had declined 28%, from $1,575,000 for the year 1926 to $1,182,000 for the year 1928, and the net earnings available for dividends had declined even more extremely, from $803,000 to $462,000. (Id., Commission's Exhibit No. X3755.)

[218] Id., at 26508 and 22116.

mediate credits as a supplement to the banking services that most of them rendered; otherwise, if there was no need for additional funds to serve that purpose, or if there was some doubt as to the future of that particular business, they did not wish to put $8,000,000 more into the company. On the other hand they were interested in intermediate credits, these bankers, and they were not interested in just a general investment trust.

* * * * * * *

Q. When you took over this concern the stockholders had partly paid for one of the classes of stock and had an obligation of about $8,000,000 on that, had they not?

A. That is right, and what we took over was their stock interests that is most of it and the obligation to contribute the additional capital.

Q. In other words by your taking over these securities you relieved them of that obligation to pay the remaining installments?

A. * * * [That] might fairly be said, though that obligation was not very pressing in view of the character of the company.

Q. Still the [obligations] were outstanding on demand, were they not?

A. That is right.

Q. And later you passed on [the stocks subscribed for]; it was ultimately assumed by the public or rather taken over by the public in the purchase of stock in American and Continental?

A. I think that is substantially true.

As will be discussed hereafter in more detail, the burden of the profitable sale of American and Continental Corporation to American Founders Corporation was largely passed on to the public by American Founders Corporation. At the time the management of American Founders Corporation negotiated to purchase an interest in American and Continental Corporation, they contemplated distributing part of the stock acquired to the public.[219] As a result of such resale American Founders Corporation recouped the entire excess cost of the acquisition of American and Continental Corporation,[220] and realized a profit of $692,000.[221]

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[219] Id., at 26511–2. The offer of purchase made by American Founders Corporation included a provision that International Acceptance Bank, Inc., might participate with Harris, Forbes & Co. in the distribution of part of the reclassified common stock to the public. (Id., Commission's Exhibit No. X3723.)

[220] After the distribution American Founders Corporation held 12,501 Class A shares and 50,000 common shares of American and Continental Corporation having a liquidating value of $28.70 per share (op. cit. supra, note 246) or $1,793,700 at a cost of $1,625,000. (Id., Commission's Exhibit No. X3405.)

[221] Id., Commission's Exhibit No. X3760. Harris, Forbes & Co. underwrote 325,000 common shares of American and Continental Corporation at $37 per share or $12,025,000 for redistribution at $40 per share, a gross commission of $975,000 (id., Commission's Exhibits Nos. X3752, X3756, and X3757), the distribution being made by the following (id., Commission's Exhibit No. X3795–A):

Participant	*Shares*
N. W. Harris & Company, Chicago	17, 800
Harris, Forbes & Co., Boston	75, 200
Harris, Forbes & Co., New York	125, 350
Harris, Forbes & Co., London	6, 000
United States & Overseas Corporation	5, 000
Founders General Corporation	3, 800
International Manhattan Company	49, 000
Field Glore & Ward	13, 000
Others	29, 750

(Footnote 221 is continued on p. 2150.)

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From July 1929 until December 31, 1933, American and Continental Corporation was jointly managed under contract by American Founders Corporation and the "Bank of Manhattan" (the successor of International Acceptance Bank, Inc.).[222] Under this management and the earlier management accorded the company its operations were the least unsuccessful of all the companies of the United Founders Corporation group. Of the $17,956,250 capital paid in to American and Continental Corporation [223] $2,071,565.20 or less than 11% was lost in operation.[224]

C. Capitalization of the United Founders Corporation Group

The capital structures of the publicly owned companies of the United Founders Corporation group were of two types.[225] Of the first were the capital structures of United Founders Corporation, Investment Trust Associates and American Founders Corporation which raised their capital principally by issuing common stocks and only relatively small amounts of senior securities. These three companies ultimately raised an aggregate of $411,695,217.72 by the issuance of common stock and $14,747,295.11 by the issuance of senior securities.[226] In striking contrast with the comparatively simple capitalization of these three companies were the complex capitalizations of International Securities Corporation of America, Second International Securities Corporation, United States & British International Co., Ltd., American & General Securities Corporation, and American and Continental Corporation. These latter companies ultimately raised an aggregate of $52,448,000 by

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These participants were supported by a trading syndicate composed of (id., Commission's Exhibits Nos. X3759–A and X4246 [pp. 49–50]):

The Harris Forbes Corporation	52%
N. W. Harris & Company	13%
Founders General Corporation	5%
International Manhattan Company	20%
Field Glore & Ward	10%

According to Mr. Seagrave, the details of the resale had not been fully worked out prior to purchase, although the management of American Founders Corporation had "generally an idea of what we thought they [the American and Continental Corporation common shares resold] could be placed for." (Id., at 26511–2.)

[222] Id., Commission's Exhibit No. X3418–E–1, 2, 3. Representatives of interests cosponsoring American and Continental Corporation served on the board of directors until the middle of 1935. (Id., Commission's Exhibit No. X3762.)

[223] See notes 214 and 215, supra.

[224] By November 23, 1935, American and Continental Corporation had shrunk from $17,956,250 to $8,599,072.51 as the result of the following (op. cit. supra, note 1, Commission's Exhibit No. X3419 [pp. 7, 48, 49, 59, and 71]):

Cost of repurchases of $7,500,000 5% debentures for retirement	$5, 855, 063. 25
Cash dividends paid	1, 412, 500. 00
Total returned to investors	7, 267, 563. 25
Net loss from operations	2, 071, 565. 20
Sundry expenses written off	18, 049. 04
Total	9, 357, 177. 49

However, the experience of the public investors is not strictly commensurate with this performance. Between May 31, 1929, and November 23, 1935, the company lost about $5,100,000, or 25% of the assets held at the time the public acquired a stock interest in the company, inasmuch as there had been accumulated approximately $2,150,000 undivided profits and unrealized capital gains and there had been distributed $512,500 dividends prior to the sale of any stock to the public. (Id., Commission's Exhibits Nos. X3419 [p. 71], X3752, and X3752–A.)

[225] Founders General Corporation and Founders Associates had no securities outstanding with the public, and their capitalizations will not be discussed.

[226] Op. cit. supra, note 1, Commission's Exhibits Nos. X3405, X3421, and X3424.

the issuance of debentures, $47,433,000 by the issuance of preferred stocks, $22,037,000 by the issuance of Class A common stocks and $16,234,000 by the issuance of Class B common stocks.[227]

Although ultimately American Founders Corporation had a relatively simple capital structure, during the earlier years the capital structure of American Founders Corporation was top-heavy or, in other words, included an amount of senior securities entirely out of proportion to the assets of the company. As heretofore discussed,[228] the relationship of American Founders Corporation to its managers provided for their compensation in cash and options to buy common stock of American Founders Corporation in proportion to the capital raised by American Founders Corporation and International Securities Corporation of America.[229] Consequently, the greater the amount of capital raised by American Founders Corporation, through issuance of senior securities, the greater the sponsor-manager's percentage of interest in the total outstanding common stock would become as a result of the issue to it of common shares as compensation for having raised the additional senior capital. Also, the higher the price at which the common shares of American Founders Corporation were issued to the public, the greater would be the paid-in value of the shares issued the sponsor-managers for their services at the lower option price.[230] Until the end of 1927, the managers' plans for American Founders Corporation called for limiting [231] the issuance of common stock and the raising of capital by senior financing.[232] In this respect, Mr. Bull testified:[233]

Q. But, Mr. Bull, in any event you did not encourage any market for the American Founders Corporation common stock as such?

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[227] Ibid., and id., at 22744–51 and 23036–42. Characteristic of the Class A common stocks of International Securities Corporation of America, Second International Securities Corporation, United States & British International Co., Ltd., and American & General Securities Corporation was the fact that in liquidation they were preferred over the Class B common stock to the extent of the proceeds of their issuance. The Class A common stocks of the companies enumerated were also entitled to noncumulative preferences in dividends, as well as additional participation with the Class B common stocks in current dividends and in the distribution of undivided profits on liquidation. (Id., Commission's Exhibits Nos. X3402, X3406, X3408, and X3410.) This capitalization was also characteristic of North and South American Corporation (see note 241, infra) and (to the extent of 1a preference on liquidation) of United States & Overseas Corporation. (For a discussion of United States & Overseas Corporation see ch. II of this part of the report, pp. 518 et seq.) In contrast with the Class A common stocks of the companies heretofore enumerated, the Class A common stocks of United Founders Corporation, General Investment Corporation, United States Electric Power Corporation, and American and Continental Corporation were only multiple voting stocks.

[228] See supra, pp. 2119–2121.

[229] Op. cit. supra, note 1, at 22303–6.

[230] Ibid.

[231] The limitation on issuance of the common stock facilitated the maintenance of its market price, as is discussed hereafter, pp. 2169–2170.

[232] Op. cit. supra, note 1, at 22303–6. During 1925 the American Founders Corporation preferred stock outstanding increased from $233,300 to $2,225,000 (id., Commission's Exhibit No. X3442), whereas the only newly issued common shares, 2,500 in number, were sold on credit to the sponsors (Investment Trust Associates) for $230,000. (Id., at 22307–9.) At the end of 1927, when the manager's contract was terminated, of the $16,992,295.26 capital paid into American Founders Corporation for the issuance of securities, 56% had been paid for the issuance of preferred stocks. (Id., Commission's Exhibit No. X3403 [p. 3].) In contrast, during 1928, 1929, and 1930, of the $49,778,000 raised by the issuance of securities, only 30% was paid for the issuance of preferred stock, almost all of which was within 6 months converted into common stock. (Id., Commission's Exhibit No. X3405.)

[233] Id., at 22301–2.

A. No, we did not; very much to the contrary.

Q. That is what I thought. As a matter of fact, as I recall it, Mr. Erwin stated in his testimony that the trouble was in selling the preferred, the advantage of the unit was in getting someone to take preferred.

A. That is correct.

One of the results of the issuance of senior securities by American Founders Corporation and of the practice of repurchasing large blocks of its own common stock was that from time to time prior to the end of 1927, there remained little if any tangible asset value for the common stock.[234]

The relationships that existed between American Founders Corporation as sponsor and International Securities Corporation of America, Second International Securities Corporation, United States & British International Co., Ltd., and American & General Securities Corporation supplied similar and possibly even stronger incentives for limiting the issuance of common shares by the sponsored companies. Until the end of 1926, American Founders Corporation was compensated for its services to International Securities Corporation of America by options to buy the common shares of the latter company at the original issue price ($3.7037 per share as adjusted for split-ups).[235] Consequently, the fewer common shares that were issued and the higher the price at which they were issued, the greater would be the interest American Founders Corporation might, through exercise of options, enjoy, in the undivided profits of International Securities Corporation of America and in the proceeds received from sales of common shares of International Securities Corporation of America at prices in excess of the option price. By the end of November 1926 International Securities Corporation of America had issued to American Founders Corporation options far in excess of 72% of the common shares of International Securities Corporation outstanding and shares issuable under outstanding options,[236] the effect of which was to dilute potentially the $3,376,058.56 capital paid in for the common shares and the $1,294,955.61 undivided profits by $2,795,396.[237]

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[234] The following table compares total paid-in capital and surplus, proceeds of issuance of common stock and capital, and realized surplus available for common stock (after adjusting for deferred charges and common stock in treasury) at the end of each of the first four fiscal periods (id., Commission's Exhibit No. X3403 [p. 3]):

Year	Total paid-in capital	Paid for common stock	Capital and surplus available for common stock
1924	$863,158.85	$367,908.85	[a] $11,163.48
1925	3,301,477.44	1,282,227.44	158,782.21
1926	9,622,463.73	3,829,913.73	1,451,297.31
1927	16,992,295.26	7,485,617.26	6,651,945.73

[a] Denotes deficiency to common stocks.

[235] See note 90, supra.

[236] As of November 30, 1926, International Securities Corporation of America had outstanding options to buy 610,538½ shares of its common stock at $3.7037 per share as compared with 226,466½ shares of common stock outstanding which had been issued for $3,376,058.56, including 32,557 shares theretofore issued for $120,581.57 to American Founders Corporation by the exercise of options. (Ibid.)

[237] As of November 30, 1926, International Securities Corporation of America had $4,671,-054.17 common stock capital, proprietary reserves, and surpluses available for its 226,466½

The recapitalization of International Securities Corporation of America with Class A and Class B common stock and the issuance of the Class B common stock to American Founders Corporation in settlement of the options [238] in no way removed the advantage to American Founders Corporation to be derived from limiting the issuance of additional Class A common shares to the public, inasmuch as the Class B common shares were to receive equal dividend participations per share with the Class A common shares subject however to noncumulative priorities in dividends by the Class A common shares.[239] Furthermore, upon the accumulation of $15,000,000 earned surplus, the two classes of common stock might be consolidated into one class of stock share for share.[240] Consequently, the fewer shares of Class A stock issued, the greater would be the interest of American Founders Corporation in International Securities Corporation of America by reason of owning the Class B common stock.

Second International Securities Corporation, United States & British International Co., Ltd., and American & General Securities Corporation, issued principally to American Founders Corporation Class B common stocks, which were similar to the Class B common stock of International Securities Corporation of America.[241] For contributing from 15–30% of the paid-in common stock capital, American Founders Corporation received stock entitled to from 66⅔% to 80% of the paid-in capital and surplus upon consolidation of the two classes of the stock and from 66⅔% to 80% of current earnings subject to prior noncumulative dividends on the Class A common stock.[242]

1. RESULTS OF COMPLEX CAPITALIZATION

From the point of view of the investor there were three major results flowing from the issuance of senior securities by International

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common shares outstanding. (Op. cit. supra, note 1, Commission's Exhibit No. X3400.) Were the options for 610,538½ shares at $3.7037 per share held by American Founders Corporation exercised, American Founders Corporation would have acquired, to the prejudice of the other common stockholders, 610,538½ shares of common stock having an asset value of $5,056,647 at a cost of $2,261,251, or $2,795,396 less than asset value.

[238] Id., at 23044.

[239] Id., Commission's Exhibit No. X3426.

[240] Ibid. Mr. Seagrave testified that the probability of consolidating the two classes of stock was remote because of the high dividends that first had to be maintained and the accumulation of surplus necessary as a condition precedent. (Id., at 23047–52.)

[241] This type of capitalization was also true of North and South American Corporation in which each of the Class A common shares was entitled to a priority of $36 per share on liquidation and to noncumulative preferred dividends of $2 per year and further participating dividends of 4 times the payment on a Class B share. (Keane's Manual of Investment Trusts, 1930.) The sponsors, A. G. Becker & Co., Baker Kellogg & Co., and the United Founders Corporation group, purchased for resale to the public 250,000 shares of the Class A stock for $9,000,000 and for their own investment the entire 1,000,000 shares of Class B stock for $1,000,000. (Op. cit. supra, note 1, Commission's Exhibit No. X3795.) Consequently after the payment of noncumulative dividends of $500,000, or about 5.55%, on the Class A stock, the sponsors who contributed 1/10 of the capital to the company would receive one-half of all the dividends disbursed. Assuming an earning rate of 8%, or $800,000 per year, the dividends that might be paid to the public would be $650,000, or 7.2%, on their net contribution of $9,000,000, and the dividends that might be paid to the sponsors would be $150,000, or 15%, on their net contribution of $1,000,000.

[242] Id., at 23047–52. For example, $7,400,000 was paid in for Second International Securities Corporation of America Class A common stock and $1,800,000 for the Class B common stock. Upon the consolidation of the two classes the Class A common stockholders would have an equity of but $3,739,000 and the Class B common stockholders would have an

Securities Corporation of America, Second International Securities Corporation, United States & British International Co., Ltd., American & General Securities Corporation and American and Continental Corporation.[243] In the first place, the issuance of senior securities created a leverage factor which accelerated the rate of loss to the common stockholders[244] to the point at which they stood to lose their entire investment in the company. By November 23, 1935, three of the five companies had sustained net losses in operations after payment of dividends in amounts exceeding the proceeds of the issuance of their common stocks.[245] But for the "profit" realized by reacquiring their senior securities at discounts, the three companies were without sufficient assets to meet the preferences of their senior securi-

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equity of about $15,461,000 in the capital in the total $19,200,000 of capital and surplus (including $9,200,000 paid-in capital and $10,000,000 earned surplus requisite for consolidation of the two classes of stock). (Id., at 23047–52.)

In the case of United States & British International Co., Ltd., no accumulation of surplus was prerequisite to the consolidation of Class A and Class B common stocks. Of the $4,500,000 combined paid-in capital for both classes of stock, upon consolidation of the classes of stock, the Class B common stockholders who contributed $1,000,000 would have an interest of $2,889,000 in the paid-in capital and the Class A common stockholders who contributed $3,500,000 would have an interest reduced to $1,444,000. (Id., at 23053–6.) Mr. Seagrave testified that the possible consolidation of the two classes of stock was remote because of the high dividend payments on both classes of stock requisite to the consolidation. (Ibid.) However, it is to be noted that contemporaneously with the organization of United States & British International Co., Ltd., the management of American Founders Corporation regarded 15.9% as a proper estimated earning power of the resources of International Securities Corporation of America. (Ibid.) The American & General Securities Corporation capitalization was even more extremely in favor of the sponsor. (Id., at 23063–4.)

[243] This discussion of the results of complex capitalization of the companies of the United Founders Corporation group does not exhaust the subject matter but merely points out the major results upon the companies themselves. For example, leverage by accelerating the losses (and profits) of the company applicable to common stock caused extreme fluctuations in market prices and during a period of rising market prices tended to cause the stocks to sell at premiums over asset values by reason of the acceleration in profits. However, while this and other results of complex capital structure were of serious importance to the investor this discussion will be limited to the principal results as reflected within the corporate walls and as reflected in the acts of the management.

[244] The effect of leverage (outstanding senior securities) in accelerating the loss in asset value pertaining to the junior securities is equal to the rate of loss in operation multiplied by the value of the assets prior to the loss and divided by the asset value of the junior securities prior to the loss. For example, if the rate of loss of the company were 50%, the total assets worth originally $100,000 and the value of the junior securities originally $60,000, by reason of the outstanding senior securities the rate of loss to the junior security holders would be accelerated from 50% to 50% × 100,000/60,000 or 83⅓%. However, the prospective rate of further loss to common stockholders (which changes with the changing ratio of outstanding senior securities to asset of the enterprise) would no longer be 66⅔% greater than that of the enterprise itself but would be increased to a rate 400% greater than the rate of loss to the company since a 20% loss of the remaining $50,000 assets would result in a 100% loss of the $10,000 remaining asset value of the common stock.

[245] The companies of the United Founders Corporation group in question had by November 1935 sustained the following losses in relation to their paid-in common stock capital (see notes 87, 95, 104, 115, 121, 128, 154, 156, and 224, supra):

Company	Paid-in common capital	Dividends and losses in operation
International Securities Corporation of America	$21,684,866.55	$30,284,978.41
Second International Securities Corporation	10,883,025.20	12,204,512.00
United States & British International Co., Ltd	7,219,807.62	10,367,035.57
American & General Securities Corporation	12,655,508.58	9,452,049.32
American and Continental Corporation	10,812,500.00	3,502,114.24

ties and their junior securities were totally devoid of any asset value.[246] The losses to the common stockholders of the remaining two companies were increased by reason of the leverage, although by reason of relatively smaller amounts of senior securities issued [247] the asset value was not extinguished.[248]

Inasmuch as American Founders Corporation and United Founders Corporation were the largest common stockholders of the subsidiary investment companies, they bore the greater part of the loss to the common stockholders. As of November 23, 1935, these two companies had investments in the common shares of the five subsidiaries costing $71,782,657.22 on which unrealized losses amounting to $58,972,477.72 had been sustained.[249] As of November 23, 1935, United Founders Corporation also owned 7,575,429 shares, or 84% of the total outstanding common shares of American Founders Corporation at a cost of $195,911,689.54 on which an unrealized loss of $188,896,356.19 had been sustained.[250] While this loss reflected about 84%, or $49,646,344.02, of the loss sustained by American Founders Corporation in its investment in the five subsidiaries, the balance of the loss suffered by United Founders Corporation was ac-

[246] The following table indicates the extent to which the asset value of junior securities as of November 23, 1935 (if any then existed) depended upon retirement of senior securities at a discount. Op. cit. supra, note 1, Commission's Exhibits Nos. X3402 [p. 9], X3407 [p. 9], X3409 [p. 6], X3411 [pp. 5 & 6], X3419 [p. 7] and X3405 [p. 145]:

Company	Security	Asset value of shares outstanding	Amount of surplus from retirements at a discount [a]	Approximate percentage that discount forms of the total asset value of each issue affected
International Securities Corporation of America.	Preferred stock	$6, 187, 875. 21	$6, 497, 194. 21	100
	Class A	0		
	Class B	0		
Second International Securities Corporation.	Preferred	1, 292, 265. 91		0
	Second Preferred	1, 218, 750. 00	1, 389, 106. 85	16
	Class A	1, 177, 829. 92		100
	Class B	0		
United States & British International Co., Ltd.	Preferred	1, 098, 933. 72		100
	Class A	0	1, 420, 806. 79	
	Class B	0		
American & General Securities Corporation.	Preferred	426, 500. 00		0
	Class A	5, 808, 280. 77	455, 430. 09	8
	Class B	0		
American and Continental Corporation.	Common and Class A.	8, 599, 072. 51	1, 644, 936. 75	19

[a] After deduction of discount on issuance applicable to debentures retired.

[247] See notes 154 and 214, supra.

[248] As just indicated, the discount on the retirement of senior securities naturally enhanced the asset value of the junior securities of these two companies. (See note 246, supra.)

[249] Op. cit. supra, note 1, Commission's Exhibits Nos. X3405 and X3421; and Securities Registration Statement for American General Corporation (withdrawn) File No. 2–2623–4–1 filed with the Securities and Exchange Commission, pp. 66 and 80. As heretofore noted (see note 80, supra) in addition to losses resulting from the leverage factor, a substantial part of the loss in question resulted from the purchase of stocks of subsidiaries at prices substantially in excess of paid-in asset value. American Founders Corporation sustained a loss of $59,102,790.50 in these securities as of November 23, 1935 and United Founders Corporation showed an appreciation of $130,312.78.

[250] Op. cit. supra, note 1, Commission's Exhibit No. X3421 (p. 9) and Securities Registration Statement for American General Corporation (withdrawn) Commission's File No. 2–2623–4–1, p. 80.

celerated by the existence of $15,000,000 preferred share capital outstanding in American Founders Corporation.[251]

As an aftermath of the complex capital structure of companies of the United Founders Corporation group, about 47% of the outstanding senior securities were retired at substantial discounts from their asset value. Such retirements occasioned permanent loss to the investors in the senior securities, affording a corresponding gain in asset value to the common stockholders of whom the principal one was the sponsor.

The inadequacy of seniority afforded investors in the companies of the United Founders Corporation group is best illustrated by the treatment afforded the investors in the debentures of the group. At the end of 1929 there were outstanding $52,000,000 of unsecured debentures issued by International Securities Corporation of America, Second International Securities Corporation, American and Continental Corporation, and United States & British International Co., Ltd., which had coverage in assets of almost 250% or more.[252] Three of the four indentures securing these debentures restrained the issuance of debentures unless the assets covered the face amount thereof by 180%.[253] However, as the depression continued and the market prices of the underlying securities declined one-half the asset coverage was reduced to less than the 125%[254] covenanted to be maintained at all times by the issuing companies.[255]

In the middle of 1930, in order to eliminate the impending event of default with respect to asset coverage[256] the issuing companies started to reacquire their debentures in the open market at a discount of 20% from their face amounts.[257] However, as the market continued to decline during 1931 the asset coverage of the debentures outstanding was still inadequate and the companies continued their retirement programs at discounts of 40% and more from the face amounts of the debentures.[258]

As a result of these repurchases, International Securities Corporation of America, Second International Securities Corporation, and United States & British International Co., Ltd., settled $24,149,000

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[251] American Founders Corporation had outstanding on September 1, 1929, approximately $30,000,000 preferred stock, of which approximately one-half (which was in the form of convertible allotment certificates) was converted into common stock in October and November 1929. (Id., Commission's Exhibit No. X3405 and see note 54, supra.)

[252] Op. cit. supra, note 1, Commission's Exhibits Nos. X3404 to X3419, inclusive.

[253] Ibid. Mr. Granbery stated that the group issued debentures rather than collateral trust bonds because the collateral trust bonds were not very workable in connection with changing portfolios. (Id., at 23148–9.) Mr. Granbery indicated that debentures present two weaknesses: the restrictive covenants might prove too severe; and the restrictive covenants might not be observed (id., at 23151) possibly because as a practical matter the trustees for the debenture holders could only have ascertained the breach of covenants with difficulty and were permitted to rely on the management's reports regarding observance of the covenants. (Id., at 23156.)

[254] Id. at 25322–3.

[255] Ibid.

[256] Id., at 25327.

[257] Id., Commission's Exhibits Nos. X3402, X3419, X3407, and X3409. The effect of such retirements was to reduce the ratio of debentures to assets, both by reason of reducing the total amount of debentures outstanding and by reason of the surplus accumulated from the retirements. (Ibid.) Mr. Granbery testified that the repurchase of securities by an investment company creates a potential source of abuse. (Id., at 23163.)

[258] Id., Commission's Exhibits Nos. X3402, X3419, X4133, X3407, and X3409.

of their obligations to their debenture holders by paying them $13,651,728.[259]

The ability of these companies to reacquire their obligations for about $10,497,000 less than the face amount, depended in part upon the active cooperation of Chase National Bank who, as successor of Harris, Forbes & Co., distributor of the debentures, served as the coupon paying agent.[260] Although at the time the existence of the default respecting the 125% asset coverage of the debentures was known to it,[261] Chase National Bank was requested and did withhold payment of interest on the debentures for 59 days (60 days would have been a default in payment)[262] or until the debenture holders supplied their names and addresses.[263]

The Chase National Bank which, as successor to the National Park Bank, was also the trustee for the debentures of United States & British International Company, Ltd.,[264] knew that the names and addresses were being acquired to enable the issuing companies to solicit the debenture holders to sell their debentures for 50¢ on the dollar. The bank itself had been designated agent to receive tenders of the debentures of that company and of International Securities Corporation of America and Second International Securities Corporation at 49%, 50%, and 51% of their face amounts.[265]

The cooperation of the investment banker who had distributed these debentures with the issuing companies in the retirement of their debentures at discounts was even more marked. Starting in 1931, the investment companies authorized Chase Harris Forbes Corporation, successor to Harris, Forbes & Co.,[266] to reacquire the debentures at a commission of 3% of the face amount.[267] Since the debentures were selling currently at around 50% this compensation was at the rate of about 6%. Moreover the retirements presented the investment banker and dealers an opportunity to make a double profit by switching the debenture holders into other securities which they may have been distributing at the time.[268] In this respect, Mr. Granbery of Harris, Forbes & Co. testified:[269]

Q. In cases where these debentures are brought up, do you know whether it is common practice for the dealers engaged in getting the debentures to switch the persons giving them up into new securities?

A. I would say that it is undoubtedly done quite often.

Q. Do you happen to know whether it was done in this case?

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[259] Ibid.

[260] Id., Commission's Exhibits Nos. X3401, X3418, X3406, and X3408.

[261] Id., Commission's Exhibits Nos. X4131 and X4132. On the board of directors of each of the debtor companies was an officer of the bank serving as trustee of the issue. (Id., Commission's Exhibit No. X3762.)

[262] Ibid.

[263] Id., at 25331–2 and Commission's Exhibit No. X4003.

[264] Id., Commission's Exhibit No. X3408–I.

[265] Id., Commission's Exhibits Nos. X4131 and X4132.

[266] Harris, Forbes & Co. was acquired by the Chase National Bank in the middle of 1930. For summary of the history of Harris, Forbes & Co. see Ch. II of this part of the report, note 3, pp. 501–2.

[267] Op. cit. supra, note 1, Commission's Exhibit No. X4131.

[268] In discussing the debentures retired Chase Harris Forbes Corporation referred to them as acquired "by exchange." (Ibid.)

[269] Id., at 25337.

A. I would say that certainly some of these transactions were that way, and other transactions were in cash.

Q. That would enable the dealer to get a double commission, one in persuading the man to give up his debentures——

A. Yes, sir.

Q. And another for the switch?

A. He might; yes, sir.

The debenture holders of American and Continental Corporation fared little better than those of the other companies of the group which had issued debentures. At the time that American Founders Corporation acquired joint control of American and Continental Corporation in the middle of 1929, Kuhn, Loeb & Co., which had headed the public distribution of the American and Continental Corporation debentures by its sponsors in 1928,[270] required the execution of a supplemental indenture by American and Continental Corporation as one of the conditions of relinquishing joint control.[271] One of the provisions of the supplemental indenture was that the issuing company would, at all times that any of the debentures were outstanding, maintain $11,250,000 in cash or intermediate credits.[272] By the middle of 1935, American and Continental Corporation with the assistance of Kuhn, Loeb & Co. and International Manhattan Company as purchasing agents [273] had settled $5,077,000 of its $7,000,000 obligations to its debenture holders for $3,426,000.[274]

The debenture repurchase program of the American and Continental Corporation involved impairing its $11,000,000 intermediate credit and cash position. When this was brought to the attention of the issuing company by the Bank of Manhattan Trust Company, the trustee of the debentures, the management of the issuing company proposed to escape the default by disclaiming any obligations under the supplemental indenture [275] which had been part of the consideration given by them for control of the company. However the trustee held firmly to its demand that the covenant be met and as a result the remaining debentures were called for redemption.[276]

The retirement program of the underlying companies of the United Founders Corporation proved an advantage to the parent companies almost equivalent to the disadvantage to the senior securities holders.

Theoretically, the losses in operation of these companies having a complex capital structure, were to be sustained in order first by the common stockholders, then the preferred stockholders, and finally by the debenture holders (thereby according to them the priorities represented by the company at the time of the distribution of the several classes of securities). As a matter of fact, however, to a very sub-

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[270] Id., Commission's Exhibit No. X3418.

[271] Id., Commission's Exhibit No. X4246 (pp. 28–29).

[272] Id., Commission's Exhibit No. X3418–D, 1, 2, 3, 4.

[273] Id., Commission's Exhibits Nos. X4132 and X4133.

[274] Ibid. Included in these repurchases were $964,000 debentures repurchased from the Schiff estate (Mr. Schiff had been the senior partner of Kuhn, Loeb & Co.) at 55% when the market was 43½. (Ibid.) Hugh Knowlton, a partner of Kuhn, Loeb & Co., testified that in the judgment of the management of American and Continental Corporation the repurchases at the premiums did not involve a cost greater than the open market accumulation of an equivalent amount. (Id., Commission's Exhibit No. X4246 [pp. 44–5]).

[275] Id., Commission's Exhibit No. X4246 (pp. 33–40).

[276] Ibid.

stantial extent the loss was shifted by United Founders Corporation and American Founders Corporation, which, at the end of November 1929, held a substantial majority of the common stock of each of the companies[277] to the investors in the preferred stock and debentures of the investment companies. During the years 1930–1935, inclusive, the investment companies reacquired an aggregate of $40,870,900 of their own preferred stocks and debentures for $29,463,425.31 or $11,407,-474.69 less than the preference and face value.[278] As a consequence, the senior security holders in effect sustained directly an $11,407,474.69 loss that would otherwise have been borne in the first instance by the common stockholders of which their sponsors, American Founders Corporation and United Founders Corporation, were the largest.[279] In fact, $4,504,732.69 of the $15,847,372.07 asset value of the investment of the sponsors in the underlying companies as of November 23, 1935, was the result of such retirements at a discount.[280]

[277] Id., Commission's Exhibits Nos. X3405 and X3421.

[278] Id., Commission's Exhibit No. X3424–G.

[279] Id., Commission's Exhibits Nos. X3405 and X3421. American Founders Corporation and United Founders Corporation held over 80% of the outstanding common and Class A common stocks of the 5 companies and about 50% of their preferred stocks from November 1929 to November 23, 1935.

[280] The $15,847,372.07 net asset values apply to the following securities (id., Commission's Exhibits Nos. X3405 [p. 46] and X3421 [p. 9] and op. cit. supra, note 246):

Subsidiary	Security	Shares held by American Founders Corporation and United Founders Corporation as of November 23, 1935, and net asset value thereof		Percent of liquidating value derived from surplus resulting from retirement of senior securities at a discount	Net asset values applicable to shares held by American Founders Corporation and United Founders Corporation as of November 23, 1935, derived from surplus resulting from retirement of senior securities at a discount
		Shares	Net asset value		
American and Continental Corporation.	Common and Class A.	323,322	$6,204,647.03	19	$1,178,883.11
American & General Securities Corporation.	Preferred	56	2,800.00	–	----------
	Common A	488,285	5,686,951.60	8	454,956.13
	Common B	482,640	----------	–	----------
International Securities Corporation of America.	6½% Preferred	4,128	377,598.00	100	377,598.00
	6% Preferred	11,184	1,023,085.60	100	1,023,085.60
	Common A	557,086	–	----------	----------
	Common B	579,154	–	----------	----------
Second International Securities Corporation.	1st Preferred	1,056	58,409.99	–	----------
	2nd Preferred	20,000	1,218,750.00	16	195,080.00
	Common A	293,124	918,581.57	100	918,581.57
	Common B	581,521	–	----------	----------
United States & British International Co., Ltd.	Preferred	10,937	356,548.28	100	356,548.28
	Common A	283,118	–	----------	----------
	Common B	271,931	–	----------	----------
Total	----------	----------	15,847,372.07	----------	4,504,732.69

The presence of senior securities in the capital structure of the United Founders Corporation group had as its third result a very substantial influence upon the investment policy of the companies. According to Mr. Seagrave, the issue, at inception of these organizations, of senior securities affected the investment policies of the issuing companies. At the time of organizing Second International Securities Corporation, United States & British International Co., Ltd., and American & General Securities Corporation, the management of the group felt it was necessary to invest immediately the funds of the newly organized companies in a manner that would provide income with which to meet the dividend requirements of the outstanding senior securities. As a consequence, initial portfolios were acquired from the sponsor, American Founders Corporation, including substantial blocks of securities of other companies in the group.[281] Mr. Seagrave testified that this effect of the complex capital structure upon investment policy was undesirable.[282]

A much more serious result of the large amounts of outstanding senior securities was the limitations it imposed upon the investment policy of the issuing companies. According to Mr. Rankin, the investment manager of the United Founders Corporation group,[283] the investment companies were prevented from investing in high-grade conservative investments returning a low yield on the amounts invested because the income therefrom could not bear corporate expenses and the interest and dividend requirements of the outstanding senior securities of the investment companies. In this respect Mr. Rankin testified:[284]

A. * * * For instance, when an investment company has a bond on which they have to pay 5 percent and pay 6 percent on the preferred, let us say the overall is a 5-percent requirement on its capital, that company can't very well afford to be buying bonds that yield 3 to 4 percent.

Q. So part of the danger you found in this situation is the size of your overhead compels you to the conclusion that later developments proved unsound?

A. That is generally right.

By reason of the arbitrary limitation imposed on investment policy by capital structure the only possible change in investment policy was in the direction of speculation. Mr. Rankin testified that during 1928 and 1929 the group, although it recognized their then fictitious values, adopted as one of its investment policies trading in stocks (purchase for resale at a profit within a relatively short period of time) rather than investment for a return in the form of dividends or interest (plus possibly capital gain over a relatively longer period of time). Mr. Rankin testified:[285]

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[281] Id., at 22744–51 and 23036–42.

[282] Ibid.

[283] Id., at 24814–6.

[284] Id., at 24875.

[285] Id., at 24879–80 and 24869.

Q. You also stated, Mr. Rankin, that as early as 1927, 1928, and 1929 you had concluded that values in American stocks were fictitious.[286]

A. Yes, sir.

* * * * * * *

Q. * * * Am I correct in thinking that you were much more interested in trading in 1929 than you had been in earlier years?

A. Yes, I would say I would think that was the only time when I was connected with the company that we ourselves entered into securities with any trading ideas, with any short term investment ideas, was that period of 1929 when we were getting a good deal of capital and using it on call and temporary investments.

Q. Is that your notion of the optimum function of any investment trust?

A. You mean trading?

Q. Yes.

A. No, I don't think it is a sound thing to do and you would only do it under very unusual conditions.

The results of the investment policies during 1929 will be discussed hereafter.

D. Practices in Connection With the Distribution of Own Securities

Although the debentures of the companies of the United Founders Corporation group were distributed by Harris, Forbes & Co.[287] with but few exceptions[288] the stocks issued by the companies of the group were distributed by companies of the group themselves, namely, American Founders Corporation and its wholly owned subsidiary, Founders General Corporation.[289]

According to the management of the companies of the group, the affiliation that existed between the issuing company and distributor

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[286] According to Mr. Rankin, the United Founders Corporation group itself had contributed some part to the fictitious values. Mr. Rankin testified (id., at 24880–1):

"Q. As a matter of fact, Mr. Rankin, when you put money on call as you did in 1929, didn't you help inflate prices?

"A. Yes; of the securities you do.

"Q. And if you buy later, you buy at the price you helped inflate, didn't you?

"A. That is true.

"Q. If a great many do that, you are part of the system that tends to help inflate and accordingly responsible for the deflation that must ensue.

"A. That is true."

[287] Harris, Forbes & Co. distributed $44,000,000 debentures for the group for net proceeds of $39,907,500. In addition, American and Continental Corporation sold, in 1928, $7,500,000 debentures for $7,143,750 net proceeds after $356,250 gross distributing commission to Kuhn, Loeb & Co. and its associates. (Op. cit. supra, note 1, Commission's Exhibit No. X3419 [p. 48].)

[288] Of the $800,000,000 aggregate proceeds of the issuance of securities by the companies of the group (id., Commission's Exhibits Nos. X3424–C and X3424–G) $98,210,249 were realized from public sales through independent distributors.

[289] Until late in 1928 the distribution of securities of companies of the group was handled by American Founders Corporation as the primary distributor; thereafter, Founders General Corporation, a subsidiary of American Founders Corporation, served as the primary distributor. (Op. cit. supra, note 1, at 23986 and Commission's Exhibit No. X3737 [pp. 59 and 60].) Distributing activities ended about the end of 1930. (Id., Commission's Exhibit No. X4183.)

was not a "healthy" relationship,[290] and one to which Mr. Seagrave, the president of United Founders Corporation,[291] said that he is at present "unalterably opposed."[292] Frederick S. Burroughs, one of the principal executives of Harris, Forbes & Co.[293] and president of General Investment Corporation[294] (one of the companies originated by the group, together with others) concurred in the view, stating that as a general proposition, when an investment company is engaged in security transactions with another company controlled by the same management, there is presented an obstacle to the exercise of separate, distinct, and balanced judgment by the management, to which each of the parties to the transaction is entitled.[295]

These difficulties with respect to distribution of the securities of companies of the group were real and not just theoretical. For example, during the period from November 30, 1929, until November 30, 1930, Founders General Corporation continued as the distributor of the common stock of United Founders Corporation under an arrangement which permitted Founders General Corporation to oversell the stock and to purchase the stock from United Founders Corporation at the sales price less a commission, or, at the option of Founders General Corporation, to purchase shares in the market.[296] The result of this arrangement was that during the year in question as the result of trading United Founders Corporation stock under the aegis of the option arrangement, Founders General Corporation realized $2,335,000 "profits" equal to over 50% of the $4,310,000 capital raised for United Founders Corporation.[297] Under similar arrangements during the year ended November 30, 1931, Founders General Corporation again realized "profits" equal to over 50% of the proceeds realized by United Founders Corporation from the issue and sale of stock and in fact the aggregate distributing commissions and "profits" exceeded the proceeds to the issuing company.[298]

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[290] Testimony of Don C. Wheaton. (Id., at 23141.) Mr. Wheaton, a security distributor, was from 1913 to 1930 associated with Harris, Forbes & Co., from 1933 to 1937 with Starkweather & Company, and at present with Don C. Wheaton & Company, the wholesale distributor for the securities of National Investors Corporation. (Id., at 23109–17.) From 1927 until 1935 Mr. Wheaton served as a director and at times a member of the executive committee of most of the companies of the group. (Id., Commission's Exhibit No. X3762.)

[291] Id., Commission's Exhibit No. X3762.

[292] Id., at 26640.

[293] Id., at 25295.

[294] Id., Commission's Exhibit No. X3762.

[295] Id., at 25587.

[296] Id., at 24703–8 and 24538–41.

[297] Founders General Corporation started the year in question with an oversold position of 142,038 shares (id., Commission's Exhibit No. X3790) and sold during the year 2,447,000 shares for $77,024,000. (Id., Commission's Exhibit No. X4174.) Of these shares sold, 120,000 were purchased from United Founders Corporation for $4,310,000 (id., Commission's Exhibit No. X3421) and 2,109,000 shares were covered by purchases in the open market for $70,287,000, at a net profit of $2,335,000 (id., Commission's Exhibit No. X4174) beyond commissions of $940,000 paid dealers. (Id., Commission's Exhibit No. X3709.)

[298] Starting the year ending November 30, 1931, with an oversold position of 209,000 shares of United Founders Corporation common stock, Founders General Corporation sold an additional 443,000 shares for $3,890,000. (Id., Commission's Exhibit No. X4174.) Of the total shares sold, 125,000 were purchased from United Founders Corporation for $1,062,000 (id., Commission's Exhibit No. X3421) and the remaining 526,000 shares were bought in the open market for $4,131,000, affording to Founders General Corporation a profit of $665,000 (id., Commission's Exhibit No. X4174) beyond the $791,000 commissions paid to dealers. (Id., Commission's Exhibit No. X3709.)

1. DEFECTS IN THE UNDERLYING PRINCIPLES OF DISTRIBUTION ADOPTED

Until 1929, the securities of companies in the group distributed to the public by American Founders Corporation and Founders General Corporation consisted principally of units, or allotment certificates representing units, of preferred and common shares.[299] Thereafter, Founders General Corporation distributed common stocks of the group to the public.[300]

The distribution of the units and later of the common stocks of the companies of the United Founders Corporation group were made almost continuously at constantly increasing prices[301] in accordance with a plan of distribution supplied in 1925 by Frank B. Erwin[302] who had active supervision of distribution for the group.[303] The plan contemplated the continuous distribution of the common stock or of units including common stock at constantly, if gradually,[304] increasing prices based largely on the rate of increase in asset value resulting from appreciation in the value of investments and from additional contributions to capital.[305] In other words, the price at which the stock was offered to the investors capitalized among other things the rate of increase in book value of the stock outstanding which had resulted from prior issues of the stock at prices in excess of its then current book value. This in turn permitted subsequent sales at prices in excess of book value.[306]

This constant pyramiding of offering prices of the common stocks of the group was further accelerated by annual reports and circulars. During 1928 and 1929 by transactions consistent in principle with the original theory of distribution and practiced on a vastly grander scale, an aggregate of $44,000,000 intercompany "profits" and "profits" realized from the resale of the securities issued by one of the companies of the group to another and then distributed publicly were reported, but not identified as such, to the public. In some instances allotments of the capital shares of a company were made to the affiliated companies at specified prices, without committing the affiliated companies receiving the allotment to buy the shares until after an almost immediate rise in the price of the shares allotted eliminated any risk in accepting the standing offer at the allotment price. At times, in its designed effort

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[299] Id., Commission's Exhibits Nos. X3737 (pp. 64–5), X3424–A, and X3424–B. The first securities distributed were units of preferred, second preferred, and common stock of American Founders Corporation sold to acquaintances of the organizers of that company shortly after its organization in 1922. (Id., at 22022 and 22234.) Almost immediately thereafter units of preferred and common shares of International Securities Corporation of America were offered publicly. (Id., at 22015–20, 22237, and 22301–2.)

[300] Id., Commission's Exhibits Nos. X3424–A, 3424–B, and X3424–C.

[301] Id., Commission's Exhibits Nos. X3543, X3444, and X3494.

[302] Id., Commission's Exhibit No. X3737 (pp. 61–73).

[303] Id., Commission's Exhibit No. X3737 (p. 15). Mr. Erwin testified that prior to the end of 1924 when he became associated with the management of the group, there was no principle underlying distribution except to sell as much senior securities as possible. (Id., Commission's Exhibit No. X3737 [pp. 64–7].)

[304] The advance in price was gradual dollarwise only by reason of split-ups. As adjusted for split-ups, the price of American Founders Corporation common stock advanced 6650% during its first 3 years of existence. (Id., Commission's Exhibit No. X3434.)

[305] Id., Commission's Exhibit No. X3494 (pp. 61–79).

[306] Ibid.

to afford profits to the companies of the group without risk, the management of the group even caused one of the companies to issue options for its stock to other companies of the group.[307] In other words, from time to time distribution of shares of one company would be made by another in order to give it profits which would enhance the value of its own capital shares.

Without at this time going into the essentially misleading character of such activities, several illustrations of this type of transaction will serve to demonstrate how money was raised, as much to permit affiliates to record profits as to supplement the capital resources of the issuing company. For example, on August 3, 1928, American Founders Corporation through its wholly-owned subsidiary, Founders General Corporation, gratuitously gave International Securities Corporation of America, Second International Securities Corporation, and United States & British International Co., Ltd., options to buy within three months 25,000 shares of American Founders Corporation common stock at $100 per share.[308] After an interim split-up of the shares two for one in October 1928,[309] the shares under option were resold for the account of the three option holders and a profit of $662,960.51 was realized by them.[310] In this respect Mr. Seagrave testified: [311]

Q. * * * finally, when it was profitable to take over the [shares subject to the] options for which the subsidiaries and affiliates had paid nothing, they took over the [shares subject to the] options and took the profit?

A. I think that is a true statement.

Q. I am advised, and properly so by my associates, that my statement was something of an understatement. They never did take over the contracts, they never did take over the shares actually. What happened was, wasn't it, that Founders General sold out the shares and turned over the proportion of profits to——

A. (Interposing.) On their order, yes.

According to Mr. Seagrave a primary (if not exclusive) motive for the issuance and distribution of the securities was to afford profits to affiliates: [312]

Q. But the giving of an option didn't mean, necessarily, that there was any assurance that American Founders would raise capital in this way, did it?

A. No. * * *

Q. * * * What was the purpose of giving these options?

A. I think the purpose was, frankly, the hope that they would make some money on them. * * * Here was American Founders—Founders General then—in the business of distributing securities and from time to time they [American Founders Corporation and Founders General Corporation] made a profit. * * * Here were the companies that [American Founders Corporation] had managed, having no opportunity to do so. This was arranged in the hopes that that would turn out profitably for them.

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[307] A detailed study of the profits realized and of the accounting abuses connected therewith is set forth in subsequent sections of this chapter.

[308] Op. cit. supra, note 1, Commission's Exhibit No. X3604.

[309] The shares were split up 2 for 1 pursuant to the transformation of American Founders Trust to American Founders Corporation. (Id., Commission's Exhibit No. X3404–D–2.)

[310] Id., Commission's Exhibits Nos. X3603, X3604, and X3847.

[311] Id., at 23027.

[312] Id., at 23021 and 23024–5.

Q. * * * If money could be made for these Companies, Second International, International, and United States & British International, why could it not have been made for American Founders?

A. It all depends on where you start. If American Founders had not planned to do this [to give these companies an apportunity to profit], in all probabilities there wouldn't have been, probably, any sale to Founders General until Founders General had a place for them [the shares], and then they [the shares] would have been sold to the market existing at that time. * * *

Q. But what did these companies do to earn the profit, did they do anything?

A. Yes; as applied to this particular transaction—no; they gave no amount of money. They didn't buy these options, they were given to them as I understand it; but there was a relationship between American Founders and these companies—fiscal contracts between them.

American Founders was trying to do a good job in advising them about their investments. Necessarily there were times when American Founders wasn't ready to make recommendations, cash was held from time to time, and American Founders Corporation did, and continued to feel a responsibility toward these companies.

They [the management of American Founders Corporation] felt they were doing a good job; and wished they were able to do a better one, and there was that sense of obligation which probably prompted the giving of these options.

Again in February 1929, a similar series of transactions was effected by the companies of the United Founders Corporation group. At this time, Founders General Corporation purchased from United Founders Corporation 205,000 shares of its common stock for $2,062,500.[313] On February 8, 1929, Founders General Corporation gave its affiliated companies an option to buy the shares within 30 days at the same price.[314] Between February 25 and February 27, 1929, the affiliated companies of the group exercised the options and immediately resold the 205,000 shares of stock in part through Founders General Corporation for an aggregate profit of $2,198,953.75.[315] And a third time, in June 1929, United Founders Corporation, Founders General Corporation and the affiliated investment companies of the group entered into arrangements whereby the affiliated companies without risk were permitted to realize $2,304,593.37 profit exclusive of a $300,000 commission to Founders General Corporation.[316] On June 10, 1929, United Founders Corporation gave an option to purchase 200,000 shares of its common stock within 60 days at $41.00 per share to Founders General which assigned the option to its affiliated companies.[317] During July 1929, the affiliated companies had Founders General Corporation sell for their account the 200,000 shares in question for aggregate proceeds of $10,804,593.37,[318] and had Founders General Corporation simultaneously exercise the option at a price of $8,200,000,[319] or $2,604,593.37, less than was realized on the resale. Consequently without any risk whatsoever,[320] the companies were

[313] Id., Commission's Exhibit No. X3692.

[314] Ibid.

[315] Id., Commission's Exhibits Nos. X3692 and X3671.

[316] Id., Commission's Exhibit No. X3699.

[317] Id., Commission's Exhibit No. X3698.

[318] Id., Commission's Exhibit No. X3699.

[319] Id., Commission's Exhibit No. X3696.

[320] Id., Commission's Exhibit No. X3698.

enabled to realize the $2,604,593.37 profit, of which $300,000 was paid to Founders General Corporation as a commission.[321]

In addition to formal option arrangements, each time new companies (the securities of which were generally more easily distributed)[322] were formed, their stocks were allotted in part to the older companies of the group, the investment, however, involving neither cash outlays or commitments to purchase.[323] The allotted securities were then resold at a profit in intercompany transactions or publicly distributed by Founders General Corporation for the account of the companies to which allotted, at substantial profits. American Founders Corporation in turn continued to realize substantial profits on the resale of the common shares of its affiliates, the market price of which increased in part based on the profits derived from sales of securities of other affiliated companies.[324]

Mr. Seagrave, who indicated his present disapproval of the transactions described,[325] explained that the consideration to the shareholders of American Founders Corporation for the issuance of such options was the enhanced value of the investment of American Founders Corporation in the stock of the affiliates which derived profits from the options given by American Founders Corporation.[326] Obviously, apart from the conflict in interest involved in a distribution of the securities of affiliates by the companies of the group, such cross-distribution by the group was even more objectionable than the continual distribution of securities at ever increasing prices. Cross-distribution fostered a geometric progression in the market price of the common stocks both of the issuing company and of the affiliated companies which distributed the newly issued securities. In contrast to the tendency of the market to capitalize the increase in asset value of the stock of the issuing company resulting from the continual issuance of additional shares at prices in excess of current asset value, the cross-distribution of newly issued securities by affiliated companies at a profit had a double-barreled effect: (a) the inclusion as earnings of essentially fictitious distributing profits received by the affiliated companies, with a resulting but essentially unjustified increase in the market value of their stocks; and (b) as a result of such unsound increases in market value, the issuing company derived unrealized appreciation or realized profit from the resale of the stocks of the affiliated companies which had theretofore recorded the profits on the distribution of the shares of the issuing company.

The predication of the offering price of stock upon the results of prior distribution is defective in two respects. In the first place, the more recent investor must sustain a loss in his investment when distribution is terminated. Because distribution provided the basis for a premium in the market price of the stock beyond the asset value or normal earning value of the stock, the termination of distribution results in the market price of the investment dropping to eliminate

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[321] Id., Commission's Exhibit No. X3699.

[322] Id., Commission's Exhibit No. X3737 (p. 225).

[323] Id., at 230020, 223028, 23043–4, 24089, 24677–8, and Commission's Exhibit No. X3692.

[324] These transactions are discussed in detail in the succeeding section of this chapter dealing with intercompany transactions and accounting abuses.

[325] Op. cit. supra, note 1, at 23030.

[326] Id., at 23025–7.

the premium based on distribution. Thus the more recent investor, when distribution ceases, will necessarily be out of pocket such part of the cost of his investment as constitutes the premium for the contemplated results of continued distribution.

But even more important a defect is that the longer distribution is continued the greater the inevitable loss to the more recent investor when distribution terminates. In order to support the current price of the ever increasing amount of stock outstanding, there must be an ever increasing premium exacted in the most recent distribution. To provide the constantly increasing premiums, stock must be issued in either or both of two ways; either at a premium and in constantly increasing amounts or at prices constantly higher than the current paid-in value. Such a distribution necessarily breaks down of its own weight; and the longer the time before distribution ends the greater the excess of cost over asset value and consequent loss to the more recent investor who has paid the larger premium for his investment.

2. CREATION AND MAINTENANCE OF A MARKET FOR THE SECURITIES OF THE GROUP

As just pointed out, the continued distribution of securities at prices higher than asset value or at prices higher than issue or option prices in part generated additional increases in market prices. The enhancement in the value of stock resulting from the distribution of additional shares at market prices in excess of current asset value provided the basis for still higher market prices at which additional shares might be issued. However, to some extent the plan depended upon maintenance of the market of the stocks at prices in excess of asset value and in this respect American Founders Corporation and later its subsidiary [327] Founders General Corporation rendered effective service for the common stocks of the group [328] until March 4, 1931.[329]

During the early years of the United Founders Corporation group there was no outside market for the securities other than that provided by American Founders Corporation itself.[330] American Founders Corporation made the market and set the market prices at which the units of American Founders Corporation and International Securities Corporation of America were sold.[331] In this respect, Mr. Bull testified: [332]

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[327] Id., at 22084–5.

[328] Id., at 24530–4 and Commission's Exhibit No. X3737 (pp. 92–3).

[329] At that time the distributing business of Founders General Corporation was transferred to Allied General Corporation, an affiliated company jointly controlled by United Founders Corporation and the Twombly interests. (Id., at 22139.)

[330] Op. cit. supra, note 1, at 22302, and Commission's Exhibit No. X3737 (pp. 92–3). In this respect Frank B. Erwin testified that as late as the end of 1924 selling securities of American Founders Corporation would be "like selling a partnership." (Id., Commission's Exhibit No. X3737 [p. 18].)

[331] Id., at 22057 and 22278 and Commissions Exhibits Nos. X3737 (pp. 92–3) and X3444. In order to overcome the resistance to the high prices at which the stock sold (id., Commission's Exhibit No. X3543), the common shares, both of International Securities Corporation of America and of American Founders Corporation, were from time to time split up (id., Commission's Exhibits Nos. X3543, X3430, X3438, and X3404–D) to place the shares split up within popular reach. In fact, American Founders Corporation issued about 85% of all its common shares in split-ups and stock dividends. (See note 55, supra.)

[332] Id., at 22279–83.

Q. But W. R. Bull and Company had nothing to do with fixing the prices [of the stock of the group]?

A. No; I cannot say that they had nothing whatever to do with the fixing of prices.

Q. And you got your prices every day from Founders [American Founders Corporation], or I suppose your office did?

A. Yes; they must have gotten them every day.

Q. Now, is there any doubt in your mind, however, that the prices of the securities were fixed and sometimes the dealers were told what they would be in the future?

A. Yes; I believe that was the case, although I may add, Mr. Stern, I think this is a correct statement, that I learned that afterwards. I did not know it at the time.

* * * * * * *

Q. Mr. Bull, can you give any reasonable explanation why, in 1923, the price of International Securities Trust common [shares] should have risen from January, $33; to February, $55; June, $65? It was not doing much business then, was it?

A. I could not give any reason without making an exhausting examination of the records, but it might well be that the earnings, actual and prospective, would have something to do with that.

Q. But these figures were figures that were fixed. These prices were figures that were fixed by Mr. Erwin or Mr. Coombs, as the case may be, either in consultation with you or not in consultation with you?

* * * * * * *

A. Well, they were actually fixed in the office. In fact I do not know very well how else it could be, because I do not think there was much of a free market on the stock at that time. Somebody had to determine the price, but I do not think there is any doubt that the price was largely determined by not only what we thought the stock was worth, but also what those who bought the stock thought it was worth, otherwise it could not have been sold successfully.

As an inducement to the public to purchase the units, American Founders Corporation would agree to repurchase the units from the investors at the price that they had paid. Mr. Bull testified:[333]

* * * We said many times to the stockholders, "There is no market on the stock, but the company will purchase your stock so far as it is able to do so, at the price at which you paid."[334]

Although as the public interest in the companies of the group grew, an actual market developed for their securities,[335] on the whole it is

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[333] Id., at 22302.

[334] However, Mr. Bull also testified that during the early years the management of the group discouraged a market for the American Founders Corporation common stock alone (id., at 22302):

> Q. But, Mr. Bull, in any event, you did not encourage any market for the common, as such?
>
> A. No; we did not. Very much to the contrary.

In this respect Mr. Erwin testified that as late as the end of 1924 it was contemplated that American Founders Corporation would not be a party to the creation of an "outside" market for American Founders Corporation common stock for at least an additional five years. (Id., Commission's Exhibit No. X3737 [pp. 39–40].)

[335] Id., at 22297.

questionable whether a completely free market ever existed in the securities of the group during the activities of American Founders Corporation and Founders General Corporation. American Founders Corporation and Founders General Corporation continued to be the leading factors in the market. In this respect, Mr. Erwin testified: [336]

Q. As a matter of fact, you don't deny, Mr. Erwin, that Founders General was the important factor in making the market on these securities during the entire period of 1929—when I say these factors I mean [with respect to the stocks of] the United Founders and American Founders [companies]?

A. They were the leaders.

The trading and distribution were extensive. During 1929 Founders General Corporation purchased securities of its affiliates in the market for $221,558,000 and sold securities of its affiliates through dealers for $399,891,000.[337] The sales transactions were largely on an "oversold" basis [the sale of securities not owned at the time of sale] in order, according to Mr. Seagrave, ostensibly to facilitate purchases and sales by the public. Mr. Seagrave testified: [338]

A. Well, I don't understand the nature of those figures [the summary of Founders General Corporation's purchase and sale blotters appearing in Commission Exhibit No. X3580]. I don't know whether they include the securities which were taken down for original issue for distribution or not, whether they include United Founders or all its securities in the group or the entire securities of the company. I mean, if you want my opinion or any comment from me, I must understand the nature of the figures, because it is my opinion that at least two-thirds of that activity was a mere passing through the shop.

Q. What do you mean by "passing through the shop"?

A. I mean by that that we have an orderer [seller] on one side and we have a purchaser on the other side. There are two very important characteristics of what is sometimes loosely called trading. One is buying for the account of a known purchaser who stands there ready to take the stock and the other is buying to take into your own account for the purpose of holding it for a profit. The greater part of the activities of Founders General were, in my opinion, of the former class.

On the other hand, Mr. Erwin, who had charge of the distribution of the group,[339] testified that although during the earlier years increased demand at times carried the price of the shares higher than contemplated, the trading activities of American Founders Corporation served to determine the market prices of the securities of the group. Mr. Erwin testified: [340]

Q. And you said at first they (American Founders Corporation) were the market, then you changed that, to say that they were the leaders in the market?

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[336] Id., Commission's Exhibit No. X3737 (p. 218).

[337] Id., Commission's Exhibit No. X3580. These figures summarize the purchase and sale blotters of Founders General Corporation and in the main represent transactions with outsiders, group transactions being usually entered in the general journal. (Id., at 22159.)

[338] Id., at 22149–50.

[339] Id., Commission's Exhibit No. X3737 (p. 15).

[340] Id., Commission's Exhibit No. X3737 (pp. 92–3).

A. Well, as we grew along almost all of the important security houses with whom we did business had a trading department and they did more or less trading in and out of our securities in their own office.

Q. But it was all predicated pretty much upon the market you made?

A. Yes; but on the other hand if they couldn't get the stock they would bid up for it. You see, we were pinned down by holding the preferred and common together. You can always sell a lot of the equity, but you couldn't sell the preferred, and we wanted to maintain as nearly as we could that senior capital relationship, and we didn't want more common to get out than necessary.

Q. As a matter of tradition and practice, if the main distributor of a security pulls away from the market, the houses who have trading departments will follow the trend of the sponsor?

A. Correct; but sometimes they forced us to bid up the market.

Q. With you being in control of the issuance of securities, you can always take care of their appetite on that score, if you think the market is too high.

A. We could in later years, but at that time we did not sell any common stock separately from the preferred.

Nevertheless, despite the activities of American Founders Corporation in making the market for the securities of the group, in its annual report for the year ending November 30, 1927, which was released about March 18, 1928, American Founders Corporation advised its stockholders: [341]

A broad free market exists for the securities of the trust [American Founders Corporation]. The trust [American Founders Corporation] does not maintain a market for its own securities.

Upon succeeding to the distributing activities of American Founders Corporation, Founders General Corporation also largely determined the market prices of the securities of the group, establishing both the over-the-counter [342] and Boston Stock Exchange prices. Mr. Thomas H. Benton, the head of the trading department of Founders General Corporation,[343] testified:[344]

Q. And the quotations on the Boston Stock Exchange, the quotations that Wrenn [Wrenn Brothers, the specialist in the stocks of the group traded on the Boston Stock exchange [345]] had, were figures that you furnished to them?

A. The market in Boston largely was affected by our purchases up there.

Q. In other words, Wrenn would start in the day with particular instructions with a book that contained your requirements, and so forth, as to buying and selling?

A. They were in connection with us all the time, and largely all day long, and would give us the market and if there was an offering there that we thought was below the counter [current or over-the-counter?] market, we very often bought it.[346]

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[341] Id., at 22917 and Commission's Exhibit No. X3466–A (p. 12).

[342] Id., at 24537–9.

[343] Id., at 24521.

[344] Id., at 24542.

[345] Id., at 24542–3.

[346] Mr. Benton testified that the same relationship also existed with Mr. Sykes, the specialist in stocks of the group traded on the New York Curb Exchange on an unlisted basis, and that the volume of trading was substantially the same on both exchanges. (Id., at 24542–3.)

In its trading activities on the Boston Stock Exchange, Founders General Corporation

In its activities Founders General Corporation "had the advantages that a specialist in any stock" listed on an exchange had. Mr. Benton testified:[347]

Q. You were a specialist and trading for your own accounts or controlled accounts under you?

A. Very much like that I would say.

Q. And you had the "book" which is the most important thing that reveals the information to you?

A. I would not know just how to put that because all our trading was over the telephone.

* * * * * * *

Q. * * * You had it all before you and weren't you in a position to trade advantageously for your own interests?

A. I wouldn't say that we knew all the time exactly what was going on in the market. We tried to keep posted because we had a 'book' as you put it * * *.

* * * * * * *

Q. It strikes me that perhaps you had an unconscionable advantage over any public buyer; you were making the market; you were conditioning the market, so you say; you had the 'book' as the specialist knew it; you had all the information.

A. We naturally had the advantage that a specialist in any stock would have.

However, Founders General Corporation had the further advantage of an ascertained source of securities to cover its oversales of stock. Mr. Benton further testified:[348]

Q. You had something more than that, didn't you? Didn't you have, in addition to being a specialist, the right, the absolute contractual right, to oversell to a large extent and to take down from the company if the market went up and to take in the market if the market went down?

A. Yes; we did.

Q. * * * You were in a position such as no other dealer in these stocks of the group was?

A. Well, I would have to agree to that. * * * The only reason why I question that at all is that I would like to put over the idea that there was really a free market in that stock outside of ours.

The activities of Founders General Corporation, similar to the earlier activities of American Founders Corporation, did more than merely facilitate the trading of others in a ready market. According to Don C. Wheaton, of Harris, Forbes & Co.,[349] Founders General Corporation

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engaged in the "manipulative" practices of establishing the opening quotations and effecting the last sale on the exchange. (Id., at 24535–6.)

The influence of Founders General Corporation through its activities on the Boston Stock Exchange was much more than local; Founders General Corporation, as a matter of practice, resold the shares bought in Boston through dealers throughout the country. (Id., at 22542.)

[347] Id, at 24538–40.

[348] Ibid.

[349] Id., at 23109.

constituted the "primary market" for the securities of the group. Mr. Wheaton testified:[350]

Q. You were asked at the private hearing whether you knew whether there was a market for the securities issued by the various companies in the group, and their affiliates. Did you know whether there was such a market?

A. I knew that Founders General published quotations on all of the Founders securities. I knew if you wanted to buy some stock you could probably get it there and likewise, if you wanted to sell any securities.

* * * * * * *

Q. Did you know who made the market?

A. I know in the case of United Founders, if you wanted to buy or sell any stock, they always had stock for sale, and made you a bid.

Q. Who do you mean by they?

A. I mean Founders General. They sent out quotation sheets and were rated as the primary market.

* * * * * * *

Q. What about the Class B stocks of International, Second International, U. S. and British International, and American and General?

* * * * * * *

A. They certainly were active in the market.

* * * * * * *

If you had any securities of any of the Founders' group for sale, the Founders General's quotation sheet showed the bid and asked.

Mr. Benton testified that Founders General Corporation made the market for the securities of the group:[351]

Q. Now, you did practically, and within the general acceptance of that term, I take it, make the market of the securities of the group * * *?

* * * * * * *

A. We did make the market in the securities because we did have a big demand for the securities that came through to our office, but there was a tremendous demand for the securities outside that did not reach us, buying and selling between brokers, and very often they influenced the market more than we did, at times.

Q. But, mostly, that was not the case, was it?

A. No; I don't say that it prevailed all of the time or most of the time.

According to Mr. Erwin the market transactions of Founders General Corporation were designed to permit the companies of the group to derive the benefit of the continuing increase in the market value of their securities.[352]

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[350] Id., at 23119–21.

[351] Id., at 24534. The extent to which the purchases and sales of Founders General Corporation determined the market for the securities of the group cannot be ascertained definitely inasmuch as the market was principally an over-the-counter market. Although the circumstances and condition of the market could not be ascertained, it is to be noted that the market purchases by Founders General Corporation alone exceeded all transactions in United Founders Corporation common stock on the Boston Stock Exchange until November 30, 1929. (Id., Commission's Exhibits Nos. X3580 and X3773.) Moreover, between February 8, 1929, and November 30, 1929, Founders General Corporation purchased 1,644,850 shares of United Founders Corporation common stock for $97,619,688.10 (id., Commission's Exhibit No. X3694), an amount equivalent to 27% of the shares outstanding at November 30, 1929. (Ibid.)

[352] Id., Commission's Exhibit No. X3737 (p. 228). For example, in February 1929, when United Founders Corporation was organized, the companies of the group subscribed for

A second technique used by Founders General Corporation to support its marketing of the common stock of American Founders Corporation and United Founders Corporation was the "oversale" of the stock being distributed. The oversales by Founders General Corporation were protected by arrangements with the issuing company whereby, having sold shares which it did not own, Founders General Corporation could either cover the sales by purchasing a requisite number of shares from the issuing company at the sales price less a commission, or could buy shares in the market for its own account.[353] The oversold position of Founders General Corporation served the two-fold purpose of giving Founders General Corporation buying power in the event the market developed weaknesses and of discouraging short sales by others which might weaken the market.[354]

By the end of June 1929, the oversold position in Founders General Corporation in the common stock of American Founders Corporation alone, amounted to 181,818 shares[355] having a current market value of $106½ per share or $19,363,617. At the end of August 1929, Founders General Corporation was oversold 409,761 shares of United Founders Corporation common stock[356] having a current market price of $67½ per share or $27,658,867.50.

Although the distribution of the stock of American Founders Corporation was facilitated by this oversold position, since the pro-

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533,213 shares of United Founders Corporation common stock at $10.50 per share in addition to 71,850 shares which were reallotted to dealers at that same price. (Id., Commission's Exhibits Nos. X3668 and X3687.) These shares were resold at a profit of approximately $5,414,375.31 (id., Commission's Exhibits Nos. X3694, X3671, and X3704) in a market supported in part at least by Founders General Corporation's purchases of 75,775 shares for $1,459,282.50 (id., Commission's Exhibits Nos. X3694 and X3737 [pp. 209–215]) or for about twice the current issue price. The maintenance of a market at the advanced price also permitted United Founders Corporation to issue additional shares in March 1929 at $27.21 per share (id., Commission's Exhibit No. X3737 [pp. 214–5]) or over twice the previous issue price.

[353] Id., Commission's Exhibits Nos. X3695, X3705, X3698, X3699, X3701, X3724, X3721, X3722, X3719, and X3713.

[354] Id., Commission's Exhibit No. X3737 (pp. 243–4). Obviously if Founders General Corporation were to cover any substantial part of a large oversold position by purchases in the market, the market would be strengthened. Were there at the time Founders General Corporation started buying, any "short" sales outstanding the market would be further strengthened by the purchases of "short" sellers forced to cover their short sales in the rising market spurred by Founders General Corporation's purchases. According to Mr. Erwin the maintenance of an oversold position served to scare off short sales; the dealers in the stocks of the group knew that Founders General Corporation maintained tremendous oversold and "short" positions in the stocks being distributed, that traders who might be tempted to make substantial short sales were discouraged and that consequently any pressure of "short" sales by outsiders on the distributing activities of Founders General Corporation was avoided. (Ibid.)

[355] Id., Commission's Exhibit No. X3722. These oversold shares were delivered by borrowing from United Founders Corporation to which Founders General Corporation gave the approximately $18,000,000 proceeds of the oversales as cash collateral. (Id., Commission's Exhibit No. X3939.)

[356] Id., Commission's Exhibit No. X3711. The oversold position of Founders General Corporation in the stock of United Founders Corporation as of the end of each month during the middle of 1929 was as follows (ibid.):

	Shares	*Proceeds*
May	89, 103	$3, 102, 093. 00
June	324, 850	16, 345, 831. 59
July	367, 457	21, 747, 457. 74
August	409, 761	26, 239, 003. 94

ceeds received by Founders General Corporation from the sales of these shares were turned over to United Founders Corporation as collateral for shares borrowed,[357] American Founders Corporation was deprived for a time of the use of that portion of the proceeds from the oversales which were subsequently covered by the issuance of new shares. By the same token, United Founders Corporation had the use of money constituting the proceeds of the distribution of American Founders Corporation Stock. Mr. Seagrave testified.[358]

Q. Isn't that an indication of a difficulty in that system, Mr. Seagrave, that this $18,000,000, instead of working in the treasury of American Founders for shares or representing shares that would later be issued, was working for United Founders?

A. Well, it may or may not have represented shares that would later be issued. I think some of them were shortly issued and some of it was covered in the market.

Q. But to the extent that the shares were taken down from American Founders, that would represent a situation in which those shares were not covered by assets for the period during which Founders General had turned over these proceeds to United Founders, isn't that true?

A. That would be true. Of course, any such oversold position is a matter of market precaution, and it was taken down as rapidly as we thought it could be prudently, and therefore I think that the net effect was that American Founders got the capital it was entitled to get, and got it as early as it could properly expect to get it.

Q. So that what you would say is, assuming that there was this time in which the proceeds of the shares were not working for American Founders, that that was offset by the advantages of having this oversold position?

A. That is right.

3. MISLEADING REPRESENTATIONS MADE IN CONNECTION WITH THE DISTRIBUTION OF SECURITIES

One of the more serious abuses connected with the distribution of the securities of the group was the publication of numerous misleading reports, circulars, market letters and advertisements and other information which misled or concealed from the investor the nature of his investment and of the enterprise in which he had invested his money.

Most important of these abuses was the publication of annual and interim reports based upon improper accounting principles and including, among other abuses, transactions effected for the primary purpose of dressing up the balance sheet and income statement. Accompanying annual reports were letters to stockholders, some of which had the effect of completely misleading the investors regarding the operations of the company.[359] The nature of some of the misleading statements made in letters to stockholders is illustrated, for example, in the letter to stockholders of American Founders Corporation of April 23, 1926, which contained a detailed summary of

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[357] See note 355, supra.

[358] Op. cit. supra, note 1, at 24742—4.

[359] The more important of the abuses in accounting methods and deceptions incorporated in the letters to stockholders are discussed in detail in the following section of this report dealing with accounting practices.

current investment principles, none of which were adopted in practice until after the end of the fiscal year 1925. Such changes in policies and principles, however, were not clearly identified to the stockholders.

When examined respecting this report, Mr. Seagrave testified as follows:[360]

Q. May I ask you to look through it and see if you find any place that stresses the speculative aspects?

A. No, I think not. I have read the report. I do not think the speculative is stressed in the report. I think the speculative aspects must appear in the reference to the interest in International [International Securities Corporation of America options], the character of that investment that was being made, and the long pull aspect that was [to be] derived from an examination of the balance sheet [of International Securities Corporation of America].

Q. But to be entirely fair, Mr. Seagrave, so far as there is what we might, for want of a better term, call selling or descriptive material, it pretty well stresses the conservative nature of the American Founders Trust?

A. I will have to agree with you on that. I think the emphasis undoubtedly was on that side.

Q. There is one other fact in connection with this report and we can leave it with the others. A shareholder reading this would not have had any impression that there had been any turbulent past in the history of this company up to March 1, 1926, would he?

A. No, I think that is true.

During the early years, in order to present the attractive feature of constantly increasing asset values of the common stock of International Securities Corporation of America and of American Founders Corporation [then American Founders Trust] to the public, the management of the group supplied the salesmen with estimate sheets which prognosticated earnings and asset values as much as five years in the future.[361] According to Mr. Seagrave, the use of such estimates was speculative and constituted an improper sales method. Mr. Seagrave testified:[362]

I never liked them and it took me some time to reach a conclusion that they simply should not be used. I finally went to Mr. Erwin and I said, "I do not think you should ever use these things again. What happens is that you talk to an experienced dealer; he knows what you are talking about, he knows that it is the height of speculation to tell him that something today is going to be something else five years from now, that might be all right with a sophisticated dealer, but when it gets out to a customer you cannot be sure that that idea has gotten over." I did not have much difficulty in persuading Mr. Erwin. Mr. Coombs, on the contrary, was devoted to these things, and it took me, I suppose, six or eight months from the time I strenuously opposed them until they were eliminated.

Mr. Riggs, counsel for the group, stated with respect to the use of the reports:[363]

I think we can all say that we regret ever having used any earnings projections or sales of securities on projection * * *.

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[360] Op. cit. supra, note 1, at 22690.
[361] Id., at 22686–9 and Commission's Exhibits Nos. X3680 and X3737 (pp. 108–116).
[362] Id., at 22687.
[363] Id., Commission's Exhibit No. X3737 (p. 148).

Distribution during the early years was also aided by the payment of large cash dividends on the common stocks of American Founders Corporation and International Securities Corporation of America.[364] Until the end of 1926, the major expenses of International Securities Corporation of America were paid by American Founders Corporation which capitalized almost all of such disbursements on its own books, thereby relieving both the income account of International Securities Corporation of America and the income account of American Founders Corporation of a large part of the current expenses of operation. In addition, American Founders Corporation included in its income account substantial elements of unrealized income resulting: (a) from write-ups of options received from International Securities Corporation of America;[365] (b) from accruing the interest on loans to sponsors at the rate of 14% per annum,[366] (such interest being "paid" to American Founders Corporation with shares of its own common stock);[367] and (c) by including as income the "profit" on the resale of its own common shares held in its treasury.[368] But for the creation of such "income", there could have been no payment of dividends on common stock out of so-called "earnings."[369]

Another abuse practiced in connection with the publication of sales material, was that of informing dealers of prospective rises in the market price of securities of the group. Mr. Erwin testified that the increase in the market price of the securities distributed constituted a "good selling argument."[370] During the earlier years when, as previously noted, American Founders Corporation determined the market price of the securities of the group, this selling argument was used; dealers were informed of price movements in advance.[371] In this respect Mr. Bull testified:[372]

Q. Now, there is not any doubt in your mind, however, that the prices of the securities were fixed and sometimes the dealers were told what they would be in the future?

A. Yes, I believe that was the case, although I may add, Mr. Stern, I think this is a correct statement, that I learned that afterwards; I did not know it at the time.

In 1922, at the time that the management of the member companies of the group started distribution of their security issues,[373] investment

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[364] Id., at 22282–4 and Commission's Exhibits Nos. X3435 and X3403.

[365] See discussion of accounting practices by the United Founders Corporation group, in the succeeding section.

[366] Op. cit. supra, note 1, Commission's Exhibit No. X3443.

[367] Id., at 22250–1.

[368] Id., Commission's Exhibit No. X3461.

[369] Id., at 22245 and 22435–41.

[370] Id., Commission's Exhibit No. X3737 (p. 95).

[371] Id., Commission's Exhibits Nos. X3444 and X3737 (pp. 96–104).

[372] Id., at 22280. As a selling argument to the dealer, the prospective advance in price was coupled with advantageous terms of purchase, e. g., payment by note (id., Commission's Exhibit No. X3494), installment payment (id., Commission's Exhibit No. X3443), and the opportunity to "reserve" stock at the earlier and lower market price and to pay for it after the market price had been advanced by American Founders Corporation. (Id., at 22286–9 and Commission's Exhibits Nos. X3440, X3444, X3484, X3450, X3504, and X3494.)

[373] The early distribution consisted of units of preferred and common stocks of American Founders Corporation and of preferred and common stocks of International Securities Corporation of America. (Id., at 22016 and 22037.)

companies and investment trusts were little known to American investors.[374] The technique of advertising the institution of investment companies and of identifying International Securities Corporation of America therewith has been elaborated upon in another part of this report.[375] As will be discussed hereafter, during the early years American Founders Corporation, apart from sponsoring International Securities Corporation of America, was engaged in making loans to its sponsors and speculation in the stock market financed in part by the resources of International Securities Corporation of America. However, not only did the management of the group compare International Securities Corporation of America, the investment company, with the "long-established British Investment Trusts"[376] but also the management represented American Founders Corporation, the distributing and management enterprise, to the public as partaking of the prospective safe performance of International Securities Corporation of America.[377]

From advertising that American Founders Corporation partook of the character of an investment trust, the management subsequently featured American Founders Corporation as an investment trust.[378] Despite the fact that substantial loans were being currently made to insiders[379] on May 8, 1925, the president of American Founders Corporation announced to the stockholders that the management intended to change the character of the company to a publicly owned investment institution.[380] In keeping with this announcement, investment restrictions were adopted and announced to the shareholders[381] although such restrictions were subject to change or abandonment without the consent of or notice to the shareholders.[382]

One of the more serious abuses in the distribution of the common stock of the United Founders Corporation group was the publication of circulars in which market values were ascribed to investments in affiliates acquired in exchange for stock. The effect of such circulars was to convey to the prospective investor the impression that the carrying value of the investments of the newly organized company was

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[374] Id., at 22025.

[375] See Part One (House Doc. No. 707, 75th Cong.) Ch. III, 97–100.

[376] Id., note 420.

[377] Op. cit. supra, note 1, Commission's Exhibits Nos. X3463 and X3495. Mr. Erwin, who had charge of distribution of the securities of the group (id., Commission's Exhibit No. X3737 [p. 15]) testified that the principal value upon which the distribution of American Founders Corporation securities could be conscientiously predicated was the options to buy International Securities Corporation of America common stock. (Id., Commission's Exhibit No. X3737 [pp. 35–6].)

[378] Id., Commission's Exhibit No. X3463 (p. 5).

[379] Id., Commission's Exhibit No. X3462. In March 1925 Wm. R. Bull alone owed American Founders Corporation $300,000 (id., Commission's Exhibit No. X3491) or almost 10% of the entire $3,300,000 contributed to the company by November 1925. (Id., Commission's Exhibit No. X3403.) This loan was not finally settled until November 1925, at which time American Founders Corporation repurchased 12,000 shares of its own common stock from Mr. Bull in settlement. (Id., Commission's Exhibit No. X3493.) In addition, in August 1925, American Founders Corporation loaned Investment Trust Associates, which was beneficially owned by the principal officers of the group, $230,000 against its demand notes. (Id., Commission's Exhibit No. X3462–24.) Other loans to insiders aggregated approximately $144,000. (Ibid.)

[380] Id., Commission's Exhibit No. X3495.

[381] Id., Commission's Exhibits Nos. X3496 and X3497.

[382] After January 1927, the investment restrictions were in effect nullified by removing the restriction limiting investments in a controlled company. (Ibid.)

supported by a substantially equivalent value of underlying resources. This publicity in no way called to the attention of the investor the tremendous load of the premium in market price over asset value of investments. For example, when United Founders Corporation was formed in February 1929 it issued to the sponsors and affiliated interests 1,000,000 shares of its Class A common stock and 2,400,000 shares of its common stock for $25,302,531.50 [383] of which $21,564,531.50 was paid for by exchange of securities [384] of affiliated companies having an asset value on November 30, 1928, the nearest balance sheet date, of $7,982,000.[385]

The justification for the valuations placed upon the securities of affiliates received by United Founders Corporation at its inception was the current market value of the securities acquired. Market values were of little meaning because: (a) United Founders Corporation was acquiring unmarketable blocks of stock, (b) the amounts of stock outstanding with the public were small,[356] or (c) high market prices

[383] Id., Commission's Exhibits Nos. X3666 and X3669.

[384] United Founders Corporation recorded $18,949,370 of the consideration received as being received in the form of stock. (Id., Commission's Exhibits Nos. X3668 and X3666.) However, at approximately the same time that United Founders Corporation sold $2,615,-161.50 of its stock for cash, it purchased from the subscribers $2,665,500 securities of companies of the group in the same amount and at prices equivalent to the exchange ratios pursuant to which it had issued $17,949,370 worth of its common stock. (See note 199, supra.)

[385] United Founders Corporation acquired by issue of stock the following securities (op. cit. supra, note 1, Commission's Exhibits Nos. X3681 and X3702):

Security	Number of shares	Cost	Asset value per share	Asset value
American & General Securities Corporation Class B	37,500	$450,000	1.97	$73,875.00
United States & British International Co., Ltd., Class B	11,250	191,250	4.28	48,150.00
Second International Securities Corporation Class B	15,000	366,000	3.05	45,750.00
International Securities Corporation of America Class B	12,100	419,900	4.44	53,724.00
American Founders Corporation Common	236,834	19,002,720	32.77	7,761,050.18
		21,614,870		7,982,549.18

[386] These acquisitions of United Founders Corporation bore the following relationship to the stock held by the United Founders Corporation group and by the public (id., Commission's Exhibits Nos. X3681, X3405, X3421, and X3650):

Security	Total issue	Held by United Founders Corporation	Held by group or under restriction agreements	Balance held by public
International Securities Corporation of America Class B	600,000	12,100	545,377	42,523
Second International Securities Corporation Class B	600,000	15,000	560,878	24,122
United States & British International Co., Ltd. Class B	300,000	11,250	246,022	42,728
American & General Securities Corporation Class B	500,000	37,500	428,619	33,881

were maintained by the operations of Founders General Corporation.[387]

Again in July 1929, United Founders Corporation, when it issued 1,000,000 shares of common stock in exchange for 500,000 shares of American Founders Corporation common stock, carried the 500,000 shares acquired into its investment account at the current market price of $52,500,000 [388] although the asset value thereof as of May 31, 1929, the nearest balance sheet date, was but approximately $16,-500,000.[389] Nevertheless, the distributing circulars describing United Founders Corporation included these excess values in the capitalization and assets of the corporation.[390]

The material published regarding a particular class of security and the charter provisions or condition of the company affecting that class of securities was at times even more ingeniously misleading than that published with respect to the nature of the enterprise. For example, in a special report to shareholders on March 1, 1926, Louis H. Seagrave, president of American Founders Corporation, stated: [391]

> * * * The declaration of trust provides that as a first preferred shares dividend reserve fund, there should be set aside on each dividend date, after providing for the dividends on the first preferred shares, a sum equal to 10% of the remaining net earnings. This reserve fund is to accumulate until it equals 10 times the annual first preferred dividends on shares then outstanding and shall thereafter in like manner be so maintained.[392]

In fact, no "fund" in the commonly understood sense of the word, i. e., the physical and legal segregation of cash or other tangible property for the specific purpose set forth, was ever created. Instead, American Founders Corporation merely allocated a portion of its undistributed surplus to dividend reserve accounts on its books which, while nominally serving to prevent the distribution of an equivalent amount of assets to common shareholders as dividends, still left these assets unidentified and commingled with the company's other assets and subject to the vicissitudes of business risk.[393]

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[387] It is to be noted that shortly prior to the formation of United Founders Corporation, Founders General Corporation had accumulated the following shares of stock (id., Commission's Exhibits Nos. X3772, X3776, X3790, and X3886):

Security:	*Number of shares*
International Securities Corporation of America, Class B	32, 917
Second International Securities Corporation, Class B	44, 500
United States & British International Co., Ltd., Class B	10, 590
American & General Securities Corporation, Class B	3, 179

In addition, during January and February 1929 Founders General Corporation was heading a syndicate distributing 199,000 shares of American Founders Corporation common stock, or about a 12% increase in the shares outstanding to its stockholders and to the public. (Id., Commission's Exhibits Nos. X3714 and X3715.)

[388] Id., Commission's Exhibits Nos. X3939 and X3892.

[389] Id., Commission's Exhibit No. X3939.

[390] Id., Commission's Exhibits Nos. X3420, X3687, X3929, and X3929A.

[391] Id., Commission's Exhibit No. X3463 (p. 9).

[392] International Securities Corporation of America also provided for a "Preferred Dividend Reserve Fund" (id., Commission's Exhibit No. X3425), which was in fact only a book reserve. (Id., Commission's Exhibits Nos. X3400 and X3402.)

[393] Id., Commission's Exhibit No. X3463 (pp. 14 and 15). Such a practice only nominally withheld assets. American Founders Corporation at the end of 1925 carried on its books substantial capitalized expenses and write-ups of assets, creating thereby surpluses available for dividends which were paid in cash; the payment of dividends left the preferred dividend reserve offset only by intangible assets.

This in no way assured continuity of dividend payments to preferred stockholders. On May 31, 1932, a $2,015,097.34 preferred dividend reserve existed on the books of American Founders Corporation,[394] but without the interim payments of any dividends whatsoever [395] by August 1935 the entire $2,000,000 dividend reserve had been eliminated as the result of unprofitable operations.[396]

This was not the only provision which lent ostensible but unreal protection to the preferred stockholders of American Founders Corporation. During its early years American Founders Corporation had issued circulars in connection with the distribution of its securities which stated:

> no first-preferred shares of any series may be issued unless net earnings of the trust as defined in the bylaws of the trustees for 12 consecutive months shall have been at least three times the annual aggregate requirements upon the preferred shares already issued and outstanding and the preferred shares then proposed to be issued.[397]

This provision fell short of affording adequate protection against overissue of preferred shares, inasmuch as the phrase "net earnings of the trust as defined in the bylaws" included such values as the directors of the companies chose to ascribe as income to the unmarketable options received from International Securities Corporation of America for service.[398] As is discussed hereafter in connection with the accounting practices of the United Founders Corporation Group, the reported earnings of the American Founders Corporation from 1922 until 1927 were arbitrarily determined by the directors and included values ascribed to options far in excess of any values that could be arrived at on a reasonable basis of appraisal. Furthermore, despite the fact that as of October 1, 1928, American Founders Corporation had outstanding 300,000 shares of first-preferred stock issued for $15,000,000 [399] the restrictive bylaw limiting the issue of additional preferred shares in terms of the earnings of the company was at that time eliminated without the consent of the shareholders.[400]

Perhaps the most serious abuse in the way of misleading representations occurred in May 1929 when in connection with the distribution of preferred stock of American Founders Corporation a circular was published by the management stating that the aggregate value of the com-

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[394] Op. cit. supra, note 1, Commission's Exhibit No. X3404–E–7 (p. 10). However, as of that date, $225,103.96 dividends due on the preferred stock supposedly assured by dividend reserves were then unpaid. (Ibid.) By May 31, 1935, the dividend reserve had increased to $2,025,135.01. (Id., Commission's Exhibit No. X3404–E–13 [p. 19].)

[395] Id., Commission's Exhibit No. X3405. No part of the $1,881,861.91 accumulated dividends at that date were ever paid. (Ibid.)

[396] Ibid.

[397] Id., Commission's Exhibit No. X3601.

[398] Id., at 23976–8.

[399] Id., Commission's Exhibit No. X3405 (p. 14).

[400] This provision which was included in the by-laws of the predecessor trust was not included in that of the successor corporation at the time of transformation (id., at 23977–8), although the plan of transformation published to the stockholders and in accordance with which they deposited their shares and delivered proxies stated that the corporate successor was to have "the same classes of shares of stock as those of the Trust" and would be capitalized with stock including preferred stock "to be issued in series correspondng to the present series of the Trust." (Id., Commission's Exhibit No. X3404–D–2.)

mon stock junior to the proposed issue taken at market was in excess of $160,000,000.[401] At the time the contemplated preferred stock and outstanding preferred stock aggregated $30,000,000 compared to approximately $69,000,000 of asset value.[402] By referring to the market value of the common stock of American Founders Corporation, junior to the issue being marketed, the management created an impression that the $160,000,000 referred to formed a margin of safety to the securities being distributed. In this respect Mr. Seagrave testified:[403]

I recall dissenting somewhat from that particular thing on the theory it didn't represent a real equity in the company * * *.

4. DISTRIBUTION OF SECURITIES AT EXCESSIVE PRICES

As previously pointed out, the distribution of securities by companies of the United Founders Corporation group was based on the practice of consistently selling securities at prices in excess of asset value. The following illustrations demonstrate the marked degree to which the public's investments was impaired by this practice.

In the latter part of 1927 American Founders Corporation issued to its stockholders rights to buy International Securities Corporation of America Class B common stock at $16 per share.[404] In all, approximately 94,000 shares were sold publicly for about $1,504,000,[405] which was about 320% of the current asset value of $5.02 per share,[406] resulting in a profit of $692,612.67 to American Founders Corporation.[407] Mr. Seagrave testified that the distribution of these shares was the result (a) of pressure from dealers that the stock be made available in the public market; and (b) of the desire to establish a market price for the balance of the Class B common shares held by the companies of the group,[408] which constituted 84% of the total shares outstanding, rather than the result of any judgment of the management of American Founders Corporation as to the investment value of the securities offered to the stockholders which it served. Mr. Seagrave testified:[409]

We had, not I, personally, but I recall in the organization we talked with a great many dealers to find out what they thought about them [the Class B common shares] and all of them felt that they were worth and could be readily purchased as a speculation on the future of International [International Securities Corporation of America] at prices from $16 upwards * * *.

Mr. Seagrave testified further that at the time he felt no particular concern in offering the stock at over three times its asset value al-

[401] Id., Commission's Exhibit No. X3404.
[402] Ibid.
[403] Id., at 24741.
[404] Id., at 22868–70.
[405] Id., Commission's Exhibits Nos. X4311, X4312.
[406] Id., at 22870.
[407] Ibid. The effect of this distribution was to create a profit out of which dividends would be paid back to the very person at whose expense the profit was either in whole or in part realized. (Id., at 22876–7.)
[408] Id., at 22878.
[409] Id., at 22869–70.

though the offering established a price structure for the offered securities in excess of their asset value: [410]

Q. But over and above this the selling of these securities to your own stockholders gave you an assured profit in your profit-and-loss account that you had to get out the next month and that was derived by selling these things to your shareholders at a price many times in excess of an asset value, now do you think that is sound business?

A. Yes; I thought it was sound business and I am still unable to see the basis of a criticism * * * we did accomplish a market basis for these shares. The shareholders did have an opportunity to participate if they wished to and as to the relationship of the asset value, I still think for a company of this type that that ratio was a very reasonable one in those times considering its leverage.

In October 1928, in substantially the same fashion, American Founders Corporation redistributed part of the Second International Class B common stock which it had held. American Founders Corporation announced that contingent upon its own transformation to a corporation, it would offer its shareholders Class B common stock of Second International Securities Corporation.[411] Accordingly, in October 1928, American Founders issued to its shareholders rights to buy before November 1, 1928, one share of Second International Securities Corporation Class B common stock at $16.00 per share for each 20 shares of American Founders Corporation first preferred or common stock or for each 40 shares of American Founders second preferred stock held of record October 10, 1928.[412] In all, 92,500 Second International Securities Corporation Class B common shares which had cost American Founders Corporation $3.00 per share, total $277,500 [413] and which had a current asset value of $3.05 per share [414] were resold at the option price of $16.00 per share, for a total of $1,480,000 resulting in a profit of $1,202,500.[415]

In July 1929 American Founders Corporation paid $12,958,100 for 375,000 shares of the currently reclassified common stock and 12,501

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[410] Id., at 22873 and 22879–80.

[411] Id., Commission's Exhibit No. X3649.

[412] Id., Commission's Exhibits Nos. X3649 and X3404–E–1 (p. 9).

[413] Id., Commission's Exhibit No. X3406–E–1.

[414] Id., Commission's Exhibit No. X3783.

[415] Id., Commission's Exhibit No. X3405. In support of this distribution on October 1, 1928, Founders General Corporation started buying the rights on a when issued basis. Founders General Corporation purchased for $209,639.54 a total of 456,387½ of the 1,839,977 rights issued (id., Commission's Exhibit No. X3777) and resold 119,065 rights for $59,366.07. (Ibid.) Founders General Corporation exercised the balance of the rights, thus acquiring 16,868 shares of the Class B common stock at a cost of $24.90 per share, total $420,013.20. After trading in these shares Founders General Corporation sold its accumulation of 25,000 shares to United Founders Corporation in February 1929. (Ibid. and Commission's Exhibit No. X7776.)

Of the 456,387½ rights purchased, 171,079 were acquired from insiders: W. R. Bull, 100,900; W. R. Bull & Co., 25,000; Helen & Maude Erwin, 30,264; L. R. Robinson, 2,664; T. H. Benton, 7,040; T. C. W. Nash, 4,011½; L. R. Carron, 1,200. (Id., Commission's Exhibit No. X3778.)

Although in November 1928 Founders General Corporation paid the insiders $8.90 for rights to buy each share of Class B common stock, or a price equivalent to $24.90 per share of the Class B common stock, thereafter, on January 7, 1929, the executive committee of American Founders Corporation appraised the stock at $14 per share as a conservative and permanent value. (Id., Commission's Exhibit No. X3664.)

shares of the currently reclassified Class A (multiple voting) common stock of American and Continental Corporation.[416] The shares acquired had a current asset value of $27.80 per share.[417] Almost simultaneously with its purchase, American Founders Corporation offered publicly through Harris, Forbes & Co. as distributor, 325,000 shares of the acquired common stock at a sales price of $40.00 per share.[418] Of these shares, 212,043 shares net [419] were distributed at $40 per share for $8,481,720, or $2,608,000 more than their $5,874,000 liquidating value.

5. ALLOTMENTS TO INSIDERS AND TRADING BY INSIDERS

One of the advantages to the individuals managing the group was the receipt by them and their associates of allotments of securities of the newly formed companies of the group at prices less than their initial market price. Between October 1928 and March 1929, securities of the group were issued to officers, directors, and certain employees of the group and a few of their associates at allotment prices which aggregated $24,635,112.50 less than the market price.[420] Also, as previously pointed out, the four principal officers of the group received for services common stock of American Founders Corporation having a market value, at the time of issue, aggregating $10,240,000 or $6,537,000 in excess of the book value.[421] In view of the tremendous discrepancies between market prices of the stocks and the costs at which the stock was acquired by the insiders, it is not surprising to find considerable trading in the securities of the group by insiders. The incomplete reports of the transactions in the securities of the group by nine of the principal officers indicate that they disposed of securities of the group for aggregate proceeds of at least $26,347,397.94, realizing a profit of $6,062,539.57 on the sales reported.[422]

The sales of securities of the group by insiders at a profit necessarily increased the load on the public by the excess of the sales price of the securities sold by them over their paid-in value. To some

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[416] Id., Commission's Exhibits Nos. X3723 and X3752–A.

[417] Id., Commission's Exhibit No. X3752–A.

[418] Id., Commission's Exhibits Nos. X3752, X3756, and X3757.

[419] Although the entire 325,000 shares were distributed in the first instance (id., Commission's Exhibit No. X4246 [pp. 49–50]), 112,957 shares were repurchased by the distributors in support of the market. (Id., Commission's Exhibit No. X3795–A.)

[420] Id., Commission's Exhibit No. X3739. In addition, these same persons and officers and directors of two affiliates of the group received, in September 1929, allotments of the securities of two affiliates at prices $30,167,500 less than the market price. (Ibid.) Allotments to affiliated companies of the group involved total premiums of market over cost aggregating $34,919,662.50. (Ibid.)

[421] Op. cit. supra, notes 62 and 71.

[422] Op. cit. supra, note 1, Commission's Exhibits Nos. X4318, X4327, X4322, X4007, X4319, X4323, X3936, X3948, and X3953. These reported transactions did not include any of the transactions of Mr. Coombs, one of the two original sponsors of the group. During 1926 and 1927 Mr. Coombs sold 2,815 shares of American Founders Corporation common stock for $162,964.20 (id., at 2249304 and Commission's Exhibit No. X3584–A [p. 37] and in the succeeding year Mr. Coombs sold an additional 58,000 shares of the same stock for approximately $4,000,000. (Id., at 22530 and Commission's Exhibit No. X3764.) The details available regarding the subsequent transactions of Mr. Coombs do not afford accurate analysis: in November 1928 when Mr. Coombs disposed of Investment Trust Associates to

extent the placing of this load on the public was effected by the sales of securities by insiders to Founders General Corporation which then redistributed the securities to the public. For example, on January 10, 1929, the American Founders Corporation issued to its common stockholders of record January 15, 1929, rights to buy on or before January 7, 1929, an additional share of common stock at $65 per share for each eight shares of stock held.[423] In all, there were issued 1,602,000 rights to buy an aggregate of 199,000 shares at a price of $12,935,000.[424] In order to assure raising the entire contemplated new capital, American Founders Corporation had its subsidiary, Founders General Corporation, form a syndicate to purchase and distribute such of the 199,000 shares as were not disposed of by the exercise of rights.[425]

Founders General Corporation as syndicate manager purchased gross 566,190 rights for $1,043,057.88 and although the management was offering the shares to the stockholders of American Founders Corporation at a price 240% of its asset value of $27.07 per share[426] about one-half of the rights were purchased by Founders General Corporation from officers or directors of the group as follows:[427] William R. Bull, 251,600; William A. Gutekunst, 4,250; Dean J. Almy, 3,000; George Devendorf, 600; and Don C. Wheaton, 800.[428]

Thus, before the stock reached the investor there was added to the $12,935,000 issue price constituting its cost to the investor, the sum of $1,000,000 paid for rights, and, of this $1,000,000 added cost to the investor, about one-half was the result of transactions of insiders with or through Founders General Corporation.

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the United Founders Corporation group, he formed six personal holding companies which succeeded to the assets of Investment Trust Associates, as follows (id., at 22484):

Investment General Corporation and its subsidiary,
Bond and Share Investment Company, Ltd.,
Provident General Corporation and its subsidiary,
Provident Investing Company, Ltd.,
The Second Provident General Corporation and its subsidiary,
Second Provident Investment Company, Ltd.

Two of these companies, namely, Bond and Share Investment Company, Ltd., and Provident Investing Company, Ltd., acquired 946,627 shares of United Founders Corporation common stock in February 1929 in exchange for their investment in American Founders Corporation common stock and the Class B common stocks of the four subsidiary companies. (Id., Commission's Exhibits Nos. X3672 and X3673.) However, by the middle of 1932 this investment had been reduced by 50% to between 400,000 and 450,000 shares (id., at 22533–4) largely by the device of Mr. Coombs selling the stock of United Founders Corporation "short" and borrowing from his own personal holding companies in order to make delivery. (Id., Commission's Exhibits Nos. X4330, X4331, and X4332.) The details of these sales are unknown to the Commission although apparently a good part of the stock was liquidated during 1929 at the end of which year Mr. Coombs' invested interest in United Founders Corporation had a market value of only between $25,000,000 and $30,000,000. (Id., at 22536.)

423 Id., Commission's Exhibit No. X3714.

424 Id., Commission's Exhibit No. X3715.

425 Ibid. This syndicate which was formed February 1, 1929 (id., Commission's Exhibits Nos. X3716 and X3717) was to receive $0.50 per share on the 199,000 shares of stock to be issued and in addition $3 per share on such shares not in excess of 66,000 as it might purchase and distribute. (Id., Commission's Exhibit No. X3715.)

426 Id., Commission's Exhibit No. X3405.

427 Id., Commission's Exhibits Nos. X3718 and X3719–A.

428 Mr. Bull was one of the original sponsors of the group. Mr. Gutekunst was a nominee of Mr. Coombs, the other original sponsor. Mr. Almy was a vice president of Founders General Corporation; Mr. Devendorf was a vice president of American Founders Corporation; and Mr. Wheaton was a director of American Founders Corporation. (Id., Commission's Exhibit No. X3772.) The syndicate sold 73,000 shares of American Founders Corporation common stock for $5,736,786.88, or about $78.59 per share. By the net purchase and exercise

The purchases of securities by companies in the group from insiders were at times made at prices far in excess of asset value thereby diluting the stock of companies of the group by the amount of the excess cost. For example, in September 1929, United Founders Corporation and American Founders Corporation issued to their shareholders rights to buy United States Electric Power Corporation common stock at $15 per share or $2.50 per share higher than its current asset value.[429] United Founders Corporation repurchased about 25% of the rights which it had issued and about 35% of the rights which American Founders Corporation had issued at a cost of $9,832,338.99 [430] of which at least $677,162.50 was paid directly to insiders by Founders General Corporation which accumulated the rights.[431]

6. TRANSACTIONS WITH HARRIS, FORBES & CO. AND ITS ASSOCIATES IN CONNECTION WITH THEIR DISTRIBUTION OF THE SECURITIES OF THE GROUP

As previously indicated, Harris, Forbes & Co. was the principal independent distributor of the securities of the United Founders Corporation group and was represented on most of the boards of directors by two or more representatives.[432] Although Harris, Forbes & Co. for a consideration had firmly committed itself to underwrite and distribute securities of the United Founders Corporation group, in at least two instances the United Founders Corporation group informally entered into subsequent transactions with Harris, Forbes & Co., the effects of which were to relieve Harris, Forbes & Co. of the risk of loss connected with these distributions. One of these instances was the American and Continental Corporation common stock distribution in July 1929.

In July 1929, Harris, Forbes & Co. headed a syndicate which undertook to distribute 325,000 shares of American and Continental Corporation common stock at $40 per share at a gross commission of $3 per share or $975,000 total.[433] In support of this distribution, The Harris Forbes Corporation formed a trading syndicate [434] consisting of the following interests: [435]

	Percent
The Harris Forbes Corporation	52
N. W. Harris & Co	13
Founders General Corporation	5
International Manhattan Company	20
Field, Glore & Company	10

of 528,000 rights 66,000 shares of stock were acquired by the syndicate at a cost of $5,253,359.29, or about $79.59 per share, leaving the syndicate short 7,000 shares. American Founders Corporation paid to the syndicate an additional commission of $3 per share on the excess 7,000 shares, or $21,000, and Investment Trust Associates sold the syndicate 7,000 shares for $450,870, or about $155,000 less than the current market price. (Id., Commission's Exhibit No. X3718.)

[429] Id., Commission's Exhibit No. X3422 (p. 21).

[430] Ibid. and Commission's Exhibit No. X3422 (pp. 16–17).

[431] Id., Commission's Exhibit No. X3827.

[432] For details of the relationship of Harris, Forbes & Co. to the group see Ch. II of this part of the report, note 3, pp. 501–2.

[433] Op. cit. supra, note 1, Commission's Exhibits Nos. X3756 and X3759.

[434] Id., Commission's Exhibit No. X4246 (pp. 49–50).

[435] Id., Commission's Exhibit No. X3750–A.

The Harris Forbes Corporation as syndicate manager [436] supported the distribution of the stock by purchasing shares at prices as high as $47 and $48 per share. By October 24, 1929, the syndicate had accumulated 112,957 shares [437] or about 35% of the stock to be distributed.

However, the syndicate was afforded by the United Founders Corporation the opportunity to dispose of this unmarketed balance at the original underwriting cost of $37 per share or $4,255,000. On October 24, 1929, Founders General Corporation, the wholly owned subsidiary of American Founders Corporation [438] accepted from the syndicate 115,000 shares of American and Continental Corporation common stock at $37 per share or $4,255,000 on behalf of United Founders Corporation, and simultaneously sold to the syndicate 75,000 shares of United Founders Corporation common stock [439] at $68.50 per share or $5,137,500. As a consequence the syndicate held 75,000 of the 6,000,000 outstanding shares of United Founders Corporation common stock,[440] instead of 112,957 shares of American and Continental Corporation equivalent to over 50% of the shares distributed to the public.[441] Moreover, the market for United Founders Corporation stock was supported at the time by the activities of Founders General Corporation.[442]

The other instance in which Harris, Forbes & Co. was relieved from loss occurred shortly before the American and Continental Corporation common stock distribution. On May 4, 1929, Harris, Forbes & Co. undertook to distribute 300,000 shares of newly issued $50 par preferred stock for American Founders Corporation in the form of 150,000 allotment certificates (each for two shares of preferred stock) convertible into one share of American Founders Corporation common stock.[443] The Harris Forbes Corporation oversold the issue,[444] and faced prospective losses by virtue of a rise in the market

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[436] According to James Warburg, the other members of the distributing group and trading syndicate did not even know the trading position of the trading syndicate (id., Commission's Exhibit No. X4246 [pp. 60–1]): "It was customary that when a house headed a syndicate which had a trading account, not to do that, and it was considered bad manners to ask questions about a trading account until the syndicate manager got ready to report."

[437] Id., Commission's Exhibit No. X3759–A.

[438] Id., at 22085.

[439] Id., Commissions Exhibit No. X3759–A. The resulting "short" position of the trading syndicate, amounting to 2,043 of American and Continental Corporation common stock, sold at $37 per share, was subsequently covered during the months of October, November, and December 1929 by purchases of the shares in the market at prices from $38.15 to $16.50. (Ibid.)

[440] Id., Commission's Exhibit No. X3421 (p. 39).

[441] There were distributed net to the public 212,043 shares, the difference between 325,000 shares underwritten and the 112,957 shares held by the syndicate.

[442] Founders General Corporation, during the months of October and November 1929, alone sold 808,105 shares and bought 1,000,005 shares of United Founders Corporation common stock. (Op. cit. supra, note 1, Commission's Exhibit No. X3694.)

[443] Id., Commission's Exhibit No. X3708. American Founders Corporation created the allotment certificates for which Seaboard National Bank acted as depository of underlying shares on May 15, 1929, having previously approved the sale of such allotment certificates by Founders General Corporation to The Harris Forbes Corporation on May 4, 1929, at $100 per unit less $6 commission. (Ibid.) The terms of conversion were even until February 1930, thereafter for one year a $15 cash premium was necessary to secure conversion and for a second year a $40 premium was necessary to secure conversion. (Ibid., and X3404–F4.)

[444] Id., at 24744–7. According to Mr. Seagrave there was an unwritten understanding that American Founders Corporation would supply such allotment certificates as might be neces-

price of the common shares of American Founders Corporation during the period of distribution from $100 per share to a high of $118 per share.[445] The Harris Forbes Corporation was spared any loss. American Founders Corporation created privately[446] an additional $3,250,000 of convertible allotment certificate[447] with outstanding preferred stock reacquired by Founders General Corporation.[448] Founders General Corporation resold these additional allotment certificates to The Harris Forbes Corporation[449] at an aggregate price of $163,125 less than the current market price at the time of sale.[450] Accordingly The Harris Forbes Corporation was relieved of a loss of at least $163,125 and possibly much more[451] through the sale of American Founders Corporation securities to it by American Founders Corporation and its subsidiary Founders' General Corporation at prices substantially less than market.

7. ABUSES IN CONNECTION WITH THE UNITED FOUNDERS CORPORATION GROUP SECURITY ISSUES

As previously pointed out, two of the principal abuses practiced by the management of the United Founders Corporation group in con-

sary to cover oversales made by The Harris Forbes Corporation to support the market. (Ibid.) It is to be noted however that the distributing circulars indicated only $15,000,000 of allotment certificates would be sold (id., Commission's Exhibit No. X3404) and that in the American and Continental Corporation distribution made at about the same time the option was in writing. (Id., at 24745.)

445 Since the price of the allotment certificates was determined by the price of the common stock into which they were convertible, the cost of repurchasing allotment certificates to make delivery on oversales would have been at least as much as the market price of the common shares.

446 No correction was made in the distributing circulars to correct for the distribution of an additional $3,250,000 allotment certificates. (Op. cit. supra, note 1, at 24747–51.)

447 The deposit agreement creating the allotment certificates permitted American Founders Corporation to tender any part of the $15,000,000 par amount of preferred stock theretofore outstanding to the depository in exchange for allotment certificates. (Id., Commission's Exhibit No. X3708.)

448 Ibid.

449 Id., Commission's Exhibit No. X3708.

450 The sales made to The Harris Forbes Corporation of the extra allotment certificates compared with market prices of American Founders Corporation common stock as follows (id., Commission's Exhibit No. X3786):

Date	Amount	Market price	Gross sales price	Excess over sales price and commission
	Ctfs.			
May 15, 1929	17,000	103¾	100	$63,750
June 5	4,000	102	100	8,000
June 18	3,500	106¾	100	23,625
July 1	6,000	106¾	100	20,250
July 11	2,500	107½	100	18,750
July 26	2,500	111½	100	28,750
	32,500			163,125

NOTE.—The market price used is that of the American Founders Corporation common shares into which the allotment certificates were convertible. Actually the allotment certificates had an even higher market price because while convertible into common stock they also enjoyed the seniority of the preferred stock.

451 If Founders General Corporation had not sold the additional $3,250,000 to The Harris Forbes Corporation, the latter would have had to repurchase in the market $3,250,000 or almost 22% of the $15,000,000 issue, which might have forced the price up.

nection with the issuance and distribution of securities of the group were: (a) the allotting of securities by newly formed companies to the remaining companies of the group at an aggregate price of $90,000,000 less than the opening market value of such securities established partly through the activities of Founders General Corporation; and (b) the issuance of stock to meet the exercise of options given without consideration by one of the companies of the group to other companies of the group as a result of which the latter were enabled to realize profits without investing or even risking their funds. While these two abuses were the most substantial in dollar amount, other equally or even more flagrant abuses were practiced. A few of these will be described by way of illustration.

On at least one occasion the management of the group issued the stock of one of the companies of the group to another company of the group at a price far less than the current market price although there was no previous understanding or arrangements with respect to the issuance of the stock. At the inception of United Founders Corporation in February 1929, Investment Trust Associates purchased 61,000 shares of United Founders Corporation common stock for $680,500,[452] of which 25,000 shares were set aside in an investment account and 36,000 shares were entered in a trading account.[453] Thereupon, in contravention of its charter which did not authorize short sales,[454] Investment Trust Associates sold 103,774 shares of United Founders Corporation common stock for $2,695,698 resulting in a "short sales" position in its trading account of 67,744 shares at $25.60 per share and a profit of $583,451.60.[455] By March 9, 1929, the market price of the United Founders Corporation common stock had advanced to $28 per share, which was $162,585.60 more than the sales price of 67,744 shares that Investment Trust Associates had sold "short." At that time instead of having Investment Trust Associates cover the "short" position in the market at a loss, the management of the group caused United Founders Corporation which had no obligation to issue more stock [456] to issue 67,744 shares of common stock to Investment Trust Associates at $25.60 per share,[457] or $162,585.60 less than the current market price.

At times securities of the group were issued without any consideration at all. In January 1922, when American Founders Corporation was formed, it issued $11,600 par amount of its securities to its sponsors and their associates and assumed $8,531.69 liabilities in return for a $2,030 account receivable from Mr. Coombs (then in bank-

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[452] Op. cit. supra, note 1, Commission's Exhibits Nos. X3420 and X3670–3.

[453] Id., Commission's Exhibit No. X3696.

[454] Id., Commission's Exhibit No. X3412. The management of the group had previously been advised that, in the absence of an express power of short sale, an investment company organized as a common law trust was without power to make short sales. (Id., Commission's Exhibit No. X3520.)

[455] These sales were entered in the trading account against the 36,000 shares bought, and resulted in a realized profit of $583,451.60 and a recorded short position of 67,744 shares at $25.60 per share. (Id., Commission's Exhibit No. X3866.) Actually because of the 25,000 shares in the investment account the "short sales" position was only 42,744 shares.

[456] Id., at 24674. According to Mr. Carron, treasurer of United Founders Corporation, the sales were made by Investment Trust Associates because it had stock in deliverable form and in contemplation of a subsequent authorization for issue of more stock. (Id., at 24669–70.)

[457] Id., Commission's Exhibit No. X3866.

ruptcy), $500 cash[458] and the goodwill of United Investors Service Company,[459] an inactive enterprise[460] in which the sponsors of American Founders Corporation had theretofore been interested.[461] Needless to say, this initial issuance of stock was contrary to the charter of American Founders Corporation which provided that the first preferred stock should not be issued at less than par.[462]

During the next two succeeding years American Founders Corporation issued substantial blocks of its stock to insiders on credit. The extent of these issues may be gauged by the fact that of the total 24,284 shares of common stock outstanding on October 31, 1924, at an aggregate issue price of $328,860,[463] 6,420 shares or over 25% had been originally issued to Mr. Coombs and Mr. Bull against payment by notes which were in turn "paid" in June 1924 by the surrender of the stock so issued.[464] And as late as August 1925, after the man-

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[458] Mr. Bull testified that he personally contributed the $500 cash. (Id., at 22018 and 22233.) However, even the $500 cash did not stay in American Founders Corporation. Together with the proceeds of the first public sales it was loaned to Bridgeport Rolling Mills (id., at 22238) an unsuccessful industrial plant (id., at 22036) in which Mr. Bull was interested. (Id., at 22251.)

[459] Id., at 22233.

[460] The original journal entry of American Founders Corporation was as follows (id., Commission's Exhibit No. X3432):

January 17, 1922	
C. F. Coombs Contract Account	2,030.
Organization Expenses Deferred	3,770.
Contingent Expenses from U. I. S. Co	13,831.69
Subscription Payments (Posted to Cash Book)	500.
To Bills Payable	3,581.69
To Liability for Stock not Delivered	4,950.
To Capital Stock, Common	2,900.
To Capital Stock, First Preferred	5,800.
To Capital Stock, Second Preferred	2,900.

This entry is to bring on the books of the liabilities, of the United Investors Servce Company, assumed by the Weeks, Lewis & Bull Company. Two dollars value in stock of the Weeks, Lewis & Bull Company was given for one dollar value of the United Investors Service Company. The excess being absorbed as follows:

Mr. C. F. Coombs contracts with the Weeks, Lewis & Bull Company to pay $35 of the loss on each block of stock—58 blocks are represented above. The balance of the loss or $65 a block is charged to Organization Expenses Deferred. The above Capital Stock is issued as follows:

Spencer Kingman	1 Block
L. E. Niles	5 Blocks
J. T. Larimore	3 Blocks
T. C. W. Nash	10 Blocks
W. R. Bull	10 Blocks
C. F. Coombs	19 Blocks
F. H. Wood	10 Blocks
Total	58 Blocks

Each block consists of:

2 Shares Common	Blocks
2 shares First Preferred	
2 shares Second Preferred	

[461] Mr. Bull testified that United Investors Service Company had been organized by Mr. Coombs in 1920 or 1921 for the same purposes as American Founders Corporation (Weeks, Lewis & Bull Company) and that Mr. Bull himself was invited to participate in United Investors Servce Company in 1921; however, it was decided to discontinue the company because of dissension among the organizers. "As far as the record shows," American Founders Corporation received no real assets from United Investors Service Company although Mr. Bull and Mr. Coombs "considered the associations of those former associates of United Investors Service Company as valuable." (Id., at 22019–20 and 22234.)

[462] Id., Commission's Exhibit No. X3427.

[463] Id., Commission's Exhibits Nos. X3437 and X3438.

[464] Id., at 2250 and Commission's Exhibit No. X3439.

agement had announced that the American Founders Corporation was to become a national investment institution,[465] American Founders Corporation sold 2,500 units of its stock, including the only 2,500 shares of new common stock issued and sold in that year,[466] to Investment Trust Associates, accepting a note of $230,000 in payment.[467]

In the middle of 1929, the management of American Founders Corporation group created and issued a security apparently in contravention of the provisions of the charter of the issuing company with respect to authorized capital. On May 15, 1929, the board of directors of American Founders Corporation authorized execution of an agreement between that corporation, Seaboard National Bank as depository, and Founders General Corporation, which provided for the creation of a maximum of 300,000 allotment certificates, each representing two shares of American Founders Corporation 6% series D first preferred stock and each convertible by the holder at his option into one share of American Founders Corporation common stock on or before February 1, 1932.[468] Pursuant to this agreement there were created and distributed $18,250,000 of allotment certificates.[469] The mechanics of the conversion feature of these certificates involved giving the Seaboard National Bank, as the representative of the certificate holders the right to tender for retirement by American Founders Corporation the aggregate of $18,250,000 preferred stock against payment therefor in common stock.[470] The holders of the $11,750,000 American Founders Corporation first preferred stock theretofore issued and outstanding[471] did not enjoy any such right despite the fact that the charter of American Founders Corporation provided:[472]

> All of the shares of the Preferred Stock shall have the same rights, privileges, preferences and voting powers and shall be subject to the same restrictions or qualifications thereof without distinction between the shares of the several series, except only as to the variations of the fixed annual dividend rate, and as to the price at which shares of the respective series may be redeemed, and as to the currency in which payable.

Regarding this issue, Mr. Seagrave testified:[473]

> Q. The right to tender that preferred stock for common stock, in exchange for common stock, is a right which takes that particular batch of preferred stock under the allotment certificates outside of equality with the preferred stock not under the allotment certificates?
>
> A. That is right. A man who bought some allotment certificates plus some preferred behind it paid more for it than he would pay for the preferred shares, and with it got a right. What of that? They were not preferred, they were allotment certificates.[474]

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[465] Id., at 22052.

[466] Id., at 22055–6.

[467] Id., at 22307.

[468] Id., Commission's Exhibit No. X3708. Until February 2, 1930, the conversion was even; during the following year the certificate holder was to pay $15 a certificate in addition and in the next year $40 a certificate in addition. (Ibid.)

[469] Id., Commission's Exhibit No. X3708.

[470] Ibid.

[471] Id., Commission's Exhibit No. X3405.

[472] Id., Commission's Exhibit No. X3404–B (p. 9).

[473] Id., at 24754–5.

[474] Mr. Riggs, counsel for the United Founders Corporation group, stated that, in his opinion, the issuance of the allotment certificates and preferred stocks represented thereby was legal despite the provisions of the charter. (Id., at 24758.)

8. ABUSES IN CONNECTION WITH EXCHANGE OFFERS

At various times, offers were made to investors to exchange their securities of one company in the group for securities of other companies in the group. Without exception, each exchange moved the investor to a position more remote from the assets underlying his investment. On several occasions such exchanges resulted in the investor receiving in exchange an investment of substantially less book value than the investment theretofore held.

In the earliest of these exchanges, in September 1923, the first preferred stockholders of American Founders Corporation were invited to exchange $250 par first-preferred stock for $100 par value first-preferred stock, $25 par second-preferred stock, and one share of common stock of that corporation.[475] By the time of the earliest audit of the company in October 1924, the one share of common stock for which the investor was induced to relinquish $125 of preferred stock and accept a lower dividend rate and subordination in part to another $125 of preferred stock [476] had a book value of but $111.00.[477]

In May 1925, some of the preferred stockholders of International Securities Corporation of America were permitted to surrender their investment in exchange for American Founders Corporation preferred stock and common stock,[478] representing at the time primarily an interest in options to buy International Securities Corporation of America common stock.[479] In November 1925 the management of the group exchanged American Founders Corporation preferred stock and common stock for International Securities Corporation of America common stock.[480] In other words, at this time the investors again gave up their original investment for one representing primarily an option on the purchase of a similar investment.[481]

In May 1927 the management of International Securities Corporation of America made an offer to certain of the investors in its collaterally secured bonds to exchange the bonds for units of preferred and Class A common stock.[482]

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[475] On September 23, 1923, the management of American Founders Corporation issued units consisting of 2 shares $50 par 7% preferred stock, 1 share $25 par 6% second preferred stock, and 1 share of common stock in exchange for 5 shares of American Founders Corporation 8% $50 par first preferred stock. (Id., Commission's Exhibit No. X3434.)

[476] Ibid.

[477] After an interim split-up of 5 for 1 (id., Commission's Exhibits Nos. X3437, X3438, and X3434) as of October 31, 1924, the first audit report of American Founders Corporation showed its common stock had a book value of $22.20 per share. (Id., Commission's Exhibit No. X3403.)

[478] Id., at 22685 and Commission's Exhibit No. X3500.

[479] Id., Commission's Exhibit No. X3737 (pp. 35–6).

[480] Id., Commission's Exhibit No. X3500.

[481] Id., Commission's Exhibit No. X3737 (pp. 35–6).

[482] Units of one share of International Securities Corporation of America 6% $100 par preferred stock and of one share of its Class A common stock at $137 per unit were offered in exchange for International Securities Corporation of America secured gold bonds at the following prices (id., Commission's Exhibits Nos. X3536, X3537, and X3538):

Series:	Price
6%—1928	101½
6%—1933	102½
6%—1943	102½
5%—1933	99½
5%—1943	96

In July 1929 the first large exchange was effected. The management of United Founders Corporation induced [483] the common stockholders of American Founders Corporation to exchange 500,000 shares of American Founders Corporation common stock for 1,000,000 shares of United Founders Corporation common stock.[484] Thereby these investors relinquished $2,875,000 in asset value.[485]

A substantial part of the loss of investors making the exchange was to the advantage of the management of the group. The $2,875,000 asset value relinquished to United Founders Corporation by the shareholders of American Founders Corporation accrued to the benefit of the owners of the 5,000,000 shares of United Founders Corporation common stock outstanding after the exchange.[486] Of these 5,000,000 shares outstanding, 1,934,937 shares or about 38% had been issued to the management of the group or their associates [487] and were in large measure still held by them.[488] Consequently the management of the group derived an advantage of about $1,000,000 in the exchange at an expense of $2,875,000 to the stockholders whom the management persuaded to make the exchange.

In October 1929, the management of the United Founders Corporation group induced [489] the stockholders of International Securities Corporation of America, Second International Securities Corporation, United States & British International Co., Ltd., and American & General Securities Corporation to exchange their preferred and Class A common stocks having an asset value of approximately $33,931,914 for common stock and warrants issued by American Founders Corporation having an asset value of approximately $18,453,846. In effect, these stockholders gave up $15,478,068 asset value to the remaining common stockholders of American Founders Corporation [490] of whom the management of the group were indirectly the largest by reason of their investments in United Founders Corporation.[491]

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[483] In connection with this exchange United Founders Corporation paid $1,250,000 commissions to dealers for effecting the exchange. Of this, $416,577.50 was paid to W. R. Bull & Co., Inc., which was owned by the president of one of the companies of the group. (Id. at 22221, Commission's Exhibits Nos. X3700, X3706, and X3762.)

[484] Id., Commission's Exhibits Nos. X3700 and see note 199, supra.

[485] Op. cit. supra, note 1, at 24717 et seq.

[486] Id., at 24717 and Commission's Exhibit No. X3939.

[487] The recipients of most of these 1,934,937 shares were Securities Investment Company of North America (which was owned by Messrs. Erwin and Seagrave and other officers and directors of the group), Investors General Corporation and Bond and Share Investment Company, Ltd., two personal holding companies of Mr. Coombs.

[488] At the end of 1929 Mr. Coombs alone still held between $25,000,000 and $30,000,000 of United Founders Corporation common stock valued at the current market price. (Id., at 22536 and Commission's Exhibits Nos. X4318 and X4327.)

[489] In connection with this exchange American Founders Corporation also paid commissions to dealers effecting the exchange. (Id., Commission's Exhibits Nos. X3731 and X3733.)

[490] Id., Commission's Exhibits Nos. X3729, X3730, X3733, and X3734. These values are as of November 30, 1929, the date of the nearest financial report.

[491] See notes 487 and 488, supra. In contrast to this exchange with the public on November 29, 1929, American Founders Corporation issued to its sponsor, United Founders Corporation, 49,650 shares of its common stock, having an asset value of $902,637, in exchange for 27,000 shares of United States & British International Co., Ltd., Class B common stock and 100,000 shares of American & General Securities Corporation Class B common stock, havng an aggregate asset value of $257,000. (Op. cit. supra, note 1, Commission's Exhibit No. X3736.)

With respect to the effect of the successive exchanges offered by the United Founders group to the security holders of the underlying investment companies which American Founders Corporation served in a fiduciary capacity, Mr. Seagrave testified:[492]

Q. The fact that I am trying to establish here is that stockholders holding preferred positions in these investment trusts were, as a result of these exchanges transferred to a less secure position as holders of stock on the American Founders.

A. They transferred themselves. They were opportunists.

Q. But the opportunity was offered by American Founders which was still in the position of being the fiscal agent for these companies. That is a fact, isn't it?

A. That is a statement of fact. * * *

Q. Then following this still further, there were several exchanges of United Founders for shares of American Founders?

A. That is correct.

Q. So that stockholders who had accepted these exchanges would find themselves taken from a position near the assets of these investment trusts ultimately in a position of stockholders in a top holding company?

A. To the extent that they accepted those exchanges; yes.

In retrospect Mr. Seagrave condemned the practice of sponsoring exchanges. Mr. Seagrave testified:[493]

Q. And what do you think now, Mr. Seagrave, as you now view it, of a practice which permits the managers of two trusts to switch the security holders from one into another?

A. I don't believe I have any particular approval of that practice. To the contrary, I think that it's bad practice.

In much the same way, the management of the United Founders Corporation group received in the latter part of 1929 the benefit of the conversion of American Founders Corporation preferred stock into common stock having less asset value. As previously discussed, during May, June and July 1929, allotment certificates representing $18,250,000 American Founders Corporation preferred stock and convertible into 182,500 shares of American Founders Corporation common stock were distributed by The Harris Forbes Corporation.[494] By November 30, 1929, $14,998,200 of the allotment certificates having a preferred value of that amount as well as preference in dividends, had been converted[495] into common stock having an asset value of $8,099,028.[496] The $6,899,172 difference in value thus relinquished by the preferred stockholders of American Founders Corporation accrued to the benefit of the common stockholders of American Founders Corporation, and as a consequence in large measure to the management of the group by reason of their substantial indirect interest in American Founders Corporation common stock.[497]

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[492] Id., at 22105–7.

[493] Id., at 22686.

[494] See supra, p. 2190.

[495] Op. cit. supra, note 1, Commission's Exhibit No. X4735.

[496] Because of an interim 3-for-1 split-up of American Founders Corporation common stock (id., Commission's Exhibit No. X3405), these 149,982 allotment certificates were converted into 3 times the number of shares of common stock having an asset value on November 30, 1929, of $18 per share (id., Commission's Exhibit No. X3733), or, in all, $8,099,028.

[497] To some extent it was the action of this management that brought about this conversion to their own profit. On September 11, 1929, the management of the group publicly

E. Management of Assets of the Companies of the United Founders Corporation Group

Until 1935, of the 10 investment companies of the United Founders Corporation group, American and Continental Corporation alone was managed jointly by the management of the group and outside interests.[498] The remaining investment companies had at all times a single management group under the guidance of American Founders Corporation.[499]

In large measure the managements of the various companies of the group were interlocking. American Founders Corporation did not acquire a majority stock interest in any of its subsidiary investment companies, except Founders General Corporation until October 1929. United Founders Corporation did not acquire a majority stock interest in American Founders Corporation until March 1930.[500] However, from February 1929 until March 1930, the officers and directors of United Founders Corporation constituted a majority of the executive committee and of the officers of American Founders Corporation; and from January 1922 until October 1929 the officers and directors of American Founders Corporation (and later United Founders Corporation as well) constituted a majority of the executive committee, officers (and with the exception of International Securities Corporation of America), a majority of each of the boards of directors of the other companies in the group.[501]

According to Mr. Wheaton[502] the situation with respect to the interlocking managements and boards of directors was "unhealthy":[503]

Q. * * * Is it a healthy thing or an unhealthy thing today, in the light of your experience?

A. You mean to be on so many boards with possibly conflicting interests * * *?

Q. It is an unhealthy thing?

A. Yes. * * *

Q. There is no qualification of that, is there?

A. No, sir.

American Founders Corporation held contracts for the management of four of its subsidiaries: International Securities Corporation

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announced that rights would be issued to the American Founders Corporaton common stock holders of record September 14, 1929, to buy prior to October 15, 1929, 2 shares of United States Electric Power Corporation common stock at $15 per share for each 5 shares of American Founders Corporation common stock owned. (Id., Commission's Exhibit No. X3929.) Since the United States Electric Power Corporation common stock had a current market value of $30 per share, the rights issued on each share of American Founders Corporation common stock had a market value of $6. (Since 5 such rights plus $30 would entitle the holder to 2 shares of United States Electric Power stock worth $60, the rights were worth the differential of $30, or $6 apiece.)

[498] Id., Commission's Exhibit No. X3762.

[499] American Founders Corporation, rather than the respective executive committees and boards of directors of the several companies of the group, initiated the investment policies of the companies. (Id., at 23116, 23117, and 22821.)

[500] See note 34, supra.

[501] Op. cit. supra, note 1, Commission's Exhibit No. X3762.

[502] Mr. Wheaton was associated with Harris, Forbes & Co. (id., at 23109) and served as a director and member of the Executive Committee of a number of the companies of the group. (Id., Commission's Exhibit No. X3762.)

[503] Id., at 23137–8.

of America, Second International Securities Corporation, United States & British International Co., Ltd., and American & General Securities Corporation.[504] These contracts called for American Founders Corporation to make specific recommendations of investments.[505] With the exception of United States & British International Co., Ltd., the management contracts appointed American Founders Corporation the exclusive distributing agent and gave it the right to demand the issuance of securities for distribution in unlimited quantity.[506] In the case of International Securities Corporation of America the issuance of the securities was independent of any approval by its board of directors.[507]

Domination of the United Founders Corporation system by a small group of individuals was not entirely unintentional. As previously pointed out, United Founders Corporation was organized to maintain effective control of American Founders Corporation and the companies which the latter controlled or managed. However, it was not until after United Founders Corporation had been formed that the board of directors of American Founders Corporation was informed that United Founders Corporation had been formed to secure continuity of management of the group and to avoid acquisition of control by interests not in sympathy with the "present conservative policies."[508] By that time, Messrs. Coombs, Erwin and Seagrave had already arranged to acquire[509] the Class A common stock of United Founders Corporation[510] which was entitled to one-third of the voting power of all the outstanding stock[511] and 1,575,937 or 66% of the initial 2,400,000 shares of voting common stock to be issued by United Founders Corporation in exchange for securities principally consisting of American Founders Corporation common stock theretofore issued to them solely for services.[512] By that time, also, the management, as distinguished from the boards of directors, had caused the companies of the group to purchase $3,715,000 of United

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[504] Id., Commission's Exhibits Nos. X3470, X3471, X3480, X3482, X3410, X3402, X3406, and X3408. In addition, American Founders Corporation had a one-third interest in the management contract between United States & Overseas Corporation and its sponsors (id., Commission's Exhibit No. X3424) an assigned interest of one-third the fee paid by the subsidiaries of United National Corporation for management services (id., Commission's Exhibit No. X4200) and a one-half interest in the management contract of American and Continental Corporation. (Id., Commission's Exhibit No. X3738.)

[505] Id., at 22821.

[506] Id., at 24010 and 24013.

[507] Id., at 24011. The management contract with American & General Securities Corporation, although containing a similar provision, provided that the board of directors might set a minimum issue price for the securities demanded. (Id., at 24012.) According to the counsel for the United Founders Corporation group, the intention of these contracts was to designate American Founders Corporation as the exclusive distributing agent and it was a matter of inadvertence that the approval of the directors was not preserved as a condition precedent to the issuance of securities on the demand of American Founders Corporation. (Id., at 24013.) The counsel for the group also indicated that the boards of directors probably could not have legally delegated their powers of issuance of securities by contract. (Id., at 24014.)

[508] Id., Commission's Exhibit No. X3665. The "present conservative policies" apparently included short sales by Investment Trust Associates of the stock of United Founders Corporation during February and March 1929. See supra, p. 2188.

[509] For details see supra, pp. 2142–2145.

[510] Op. cit. supra, note 1, Commissions Exhibit No. X3666.

[511] Id., Commission's Exhibit No. X3420–B–2.

[512] See note 194, supra.

Founders Corporation common stock [513] and thereby help vest the control of the group companies in the management. Thus in effect, the companies were made to cooperate in the disenfranchisement of their own stockholders.[514]

1. FAILURE OF THE DIRECTORS TO ADEQUATELY SUPERVISE THE MANAGEMENT

The contribution of the independent directors of the companies in the United Founders Corporation group to the conduct of business was negligible. Mr. Seagrave, president of United Founders Corporation and of American Founders Corporation, testified: that the directorates of American corporations were generally less competent and less active than those of English corporations; that there was and is in this country a tendency to window-dress the board of directors with well-known but relatively inactive members; and that both of these characteristics were and are true of investment companies. Mr. Seagrave accounted for the difference on two grounds: (a) in England greater civil and criminal penalties attach for breaches of trust by the director; and (b) the adequate remuneration of directors in England has developed a professional class of skill and ability independent of banking houses.[515]

For example, Mr. Granbery, of Harris, Forbes & Co.,[516] testified that he relied on the management regarding the propriety of the investments,[517] because it was impossible through directors' meetings to appraise the individual investments bought and sold.[518] According to Mr. Granbery the directors merely had general discussions of investment policy and approved the acts of the management.[519]

Dr. Kemmerer, professor of International Finance at Princeton University, who served as a director and member of the Executive Committee of a number of the companies of the United Founders Cor-

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[513] Id., Commission's Exhibits Nos. X3668 and X3671.

[514] Mr. Riggs, counsel for the United Founders Corporation group, when examined with respect to this particular transaction, testified (id., at 24495):

> Q. * * * Do you approve, as you now view it, the officers of the company using the monies of the company or its wholly owned subsidiaries to freeze themselves into the management, that is what this amounts to?
> A. Yes, I do. I believe they did it with the best of motives, best of intentions, best of purposes, and they thought it was for the interest of stockholders to do it.
> Q. As for Mr. Seagrave, the purposes of the management had not been unlucrative up to that time?
> A. I do not think that has anything to do with the purpose of such men on the Board as Mr. Makepeace, Mr. Goss, or other people who were not associated with the management and were wanting that management to continue. The laborer is worthy of his hire, and these men were making nothing but their own salaries.
> Q. It is a question of whether the laborer should press his own hire at the expense of other people. You certainly approve it?
> A. I certainly do and I think as I did at that time; they acted with the best of motives and in the interests of the corporation.

[515] Id., at 23995 and 23996.

[516] Mr. Granbery was associated with Harris, Forbes & Co., and its predecessor, N. W. Harris & Company, from 1903 to 1933, serving as a director and vice president from 1912 to 1933 and as an executive officer of its buying department from 1925 until 1933. (Id., at 23143.) Mr. Granbery served as a director of most of the companies of the United Founders Corporation group and at times as a member of the executive committee or an officer of several companies of the group. (Id., Commission's Exhibit No. X3762.)

[517] Id., at 23151 and 23156–8.

[518] Id., at 23164–5.

[519] Ibid.

poration group, testified with respect to his qualifications to pass on investments as follows: [520]

I made it perfectly clear when the matter was talked over with me that I had made no pretense to be an authority on investments and that any service I might give would necessarily be in the field of broad, general economic policies and principles and not in specific investments and from the beginning of my relations with this company I always refused to have anything to do in a specific way in regard to specific investments. That was not my field.

Accordingly, although he believed that a director should accept the responsibility the office normally involves, Dr. Kemmerer testified as follows with respect to his conduct as a director and member of the executive committee: [521]

Q. Did you look over their portfolio from time to time and acquaint yourself with the portfolio of which the various trusts had investments?

A. * * * at every meeting of the board [International Securities Corporation of America] there was presented to us a statement of the portfolio but I never passed judgment on any specific investments that I can recall.

Q. Did you ever examine the portfolio and suggest that there ought to be a shift from one country to another or shift out of certain countries in looking over the portfolios?

A. I cannot recall what I did. It is possible that I may have suggested that in view of the unsettled conditions in certain parts of Latin America that they be a little careful on Latin American securities at the time, but their investments in Latin American securities were very small and I am not sure on that point. I cannot remember.

Q. Doctor, do you recall while you were a director how investments were started and who passed upon them? How did they come to you?

A. They came to us in a report that was put upon our desks at the time of a directors' meeting—a report that came from American Founders and a report as to what had been done generally upon advice of American Founders.

Q. And what you did as a trustee was just to look over what had been done?

A. We looked them over and then we discussed questions of the policy for the future, but when they came to us they were largely records of what had been done and, of course, they raised questions as to future policies, but those reports were over, as I recall, accomplishments, things that had been done.

Dr. Kemmerer attributed his willingness to act as a director under the circumstances in part to his respect for the ability and competence of Dr. Tucker, the head economist of American Founders Corporation, and of the statistical organization of American Founders Corporation, and his willingness to accept their recommendations.[522]

Mr. Rice, president of the United States Gutta-Percha Print Company, testified regarding his services as a director of various companies in the group as follows: [523]

Q. What do you feel that you were particularly contributing to this—this was a highly technical business—Mr. Rice? What does a director who sits on a board of that kind feel? I would like to get your reaction.

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520 Id., at 23068, 23069–70, 23072–3, and Commission's Exhibit No. X3762.

521 Id., at 23072–9.

522 Id., at 23081–2 and 24922.

523 Id., Commission's Exhibits Nos. X3739 (p. 2), X3762 and X3739 (pp. 34–5).

A. Well, I feel a little foolish about it. I felt a little flattered, to tell you the honest truth, that I should be asked on because I had had no experience in buying and selling. Certainly, all I had was my own investments, such as they were, which, of course, were ridiculously small compared to things of this kind; and then I was in my term a director of two or three financial institutions, the Rhode Island Hospital Trust Company, a trustee of the Peoples Savings Bank, and a director of the Providence Washington Insurance Company—that is an investment trust; any book insurance company is—and the Providence Gas Company, and in that way you might call it a side issue because with me my main business is what I have told you and I am still in it. Perhaps, selfishly stated, I don't think that I felt as though they were going to gain so much from my being on the board as I was going to gain from being on; in seeing how these things were done.

Mr. Hall, an investment officer of the Carnegie Foundation since 1919, and a director of a number of the companies of the United Founders Corporation group, testified that the investments of the several companies were initiated by the investment department of American Founders Corporation; were acted upon by the executive committees of the various companies of the group; and that the board of directors were only asked to approve of the transactions effected and to determine policy in general. Mr. Hall further testified that the practices with respect to investments were hardly designed to utilize his particular skill and experience to the best advantage.[524]

John Goss, vice president and superintendent of Scoville Manufacturing Company, who was a director of two companies in the group, testified that he came to American Founders Corporation in order to buy an investment service and instead invested in the company and became a director.[525] However, Mr. Goss testified that he relied on Mr. Riggs, counsel for the group, to see that operations were conducted properly; Mr. Goss testified that he had no particular skill in investment nor did he ever inquire into the manner by which the companies of the group earned their money. In his capacity of director all he could do was question whether the acts of the management met the fiduciary obligations. Mr. Goss recalled no instance in which the board initiated any business.[526] Although he served as a director of American Founders Corporation from 1925, Mr. Goss had but a limited knowledge regarding who had charge of the operations of the group.[527] Mr. Goss testified: [528]

Q. * * * Who do you think was the man running the Founders Group?

A. Well, at the time I thought Louis Seagrave was doing it. Later I wasn't so sure but what Mr. Coombs and Mr. Erwin were having a good deal to say. Mr. Coombs was the originator, I think, setting up the statistical department * * *.

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[524] Ibid. and id., Commission's Exhibits Nos. X3762 and X3739 (pp. 19–22). Mr. Hall did not recall the extensive trading in securities of affiliates (id., Commission's Exhibit No. X3739 [pp. 22 and 47] a practice normally undesirable and unhealthy (id., Commission's Exhibit No. X3739 [pp. 23 and 97–8]) and at all times pertinent to the possible future success in operation. (Id., Commission's Exhibit 3739 [pp. 48 and 52].)

[525] Id., Commission's Exhibits Nos. X3762 and X4249 (pp. 2–4).

[526] Id., Commission's Exhibit No. X4249 (pp. 9, 40–41, 49–50 and 72–3)

[527] Id., Commission's Exhibit No. X3762.

[528] Id., Commission's Exhibit No. X4249 (pp. 36–8).

Q. Do you know how much stock Mr. Coombs had in American Founders when you first went there?

A. No.

Q. When did you first become aware of his holdings? [528a]

A. I think at the time United Founders was formed.

Q. Did it surprise you the amount of stock that he held?

A. I didn't like it, frankly, but I wouldn't want to say that. A man forms opinions, you know, at times that are not justified by any facts that he has and I don't like to publicize an opinion on the man that only rests upon suspicion and if Mr. Coombs were possessed of that stock at the time I discovered it, why, it was too late to prevent his having it and the only thing I did was to watch a little more closely as to what Mr. Coombs and Mr. Erwin were doing. And I think that that centered finally on the voting stock sold to the three-way division between Seagrave, Erwin, and Coombs. And I feel pretty sure that that has proved to be a very embarrassing situation for Mr. Seagrave. He might not admit it but I am pretty sure it did and he was in the position of the other two being able to outvote him and it would finally resolve under pressure that was put on the situation by the board members. As I remember it, both Erwin and Coombs finally got off the board. When they got off I don't know.

2. SUMMARY OF PERFORMANCE OF THE COMPANIES IN THE GROUP

The assets of the United Founders Corporation group were devoted principally to these purposes: investments in affiliates and subsidiaries; investment in general portfolio securities and in intermediate credits; and during the early years, in loans to and purchases made from insiders. As of November 30, 1930, the gross consolidated assets of the group consisted of the following before deducting $13,652,723.55 investment reserves: [529]

Cash and call loans	$16, 673, 150. 86
Receivables	2, 001, 533. 32
Investment in—	
General portfolio securities	159, 829, 058. 41
Intermediate credits	11, 957, 974. 74
Affiliated companies	120, 006, 025. 35
Cost of securities of subsidiaries in excess of their book values	[a] 31, 796, 061. 26
Deferred charges	4, 024, 642. 59
Gross consolidated assets	346, 288, 446. 53

[a] This excess cost is after the reduction by $110,376,956.92 of the original values placed upon securities acquired in exchanges to the stated value of the securities so acquired.

[528a] As previously indicated, Mr. Coombs had received a substantial part of the stock of American Founders Corporation for services. In February 1929 he held almost 10% of the outstanding American Founders Corporation common stock. (Id., Commission's Exhibit No. X3691.)

[529] Id., Commission's Exhibits Nos. X3420–E5 (p. 12), X3421 (p. 8), X3405 (pp. 45 and 104), X3402 (p. 10), X3407 (p. 10), X3409 (p. 9), X3411 (p. 8), X3419 (p. 12), and X3413 (p. 9). Investments in subsidiaries as of November 30, 1930, which were eliminated in consolidation (subject to the $31,796,061.26 excess cost as shown above) were as follows:

Carrying value of investment by United Founders Corporation, principally in the shares of American Founders Corporation and Investment Trust Associates	$105, 527, 055. 40
Carrying value of investment by American Founders Corporation, principally in the shares of the investment companies	71, 710, 660. 12

By November 23, 1935, the group had sustained realized and unrealized losses in operations including $98,562,750.71 on investments in affiliates and $130,660,710.81 on investments in general portfolio securities.[530]

Unreflected in this summary of the performance of the group, however, are the substantial losses sustained by the United Founders Corporation group on their investments in subsidiaries. Such losses to United Founders Corporation and American Founders Corporation were due to two factors other than the performance of the subsidiaries. First, purchases of the investments were in part made at substantial premiums above asset value. Mr. Carron, treasurer of United Founders Corporation and of American Founders Corporation, testified that those two companies acquired part of their investments in subsidiaries by paying $188,000,000 for securities having a paid-in value of but $105,000,000.[531] Second, the unmarketable investments in subsidiaries were vulnerable apart from the excess cost paid for the investments. As previously pointed out, the subsidiary companies had complex capital structures, the effect of which was to accelerate the losses to a rate substantially higher than that of the operations of the subsidiary companies. Since the holdings of the parent companies were in junior securities, they suffered proportionally a greater loss than the public did on its investment in the subsidiary companies.[532]

3. INVESTMENTS IN AFFILIATES

The investments of the group in its affiliates were strikingly similar to investments of the parent companies of the group in their subsidiary companies. These investments involved substantial participations in the distribution of securities of the affiliates at a profit; the accumulation of dominant positions at premiums in excess of asset value either by public purchase or from co-sponsors; and the sale of initial portfolios to the affiliates at a profit. The effect of the first and last of these three incidents was to limit the loss in investments in affiliates.[533] The sponsorship of affiliates, however,

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[530] Id., Commission's Exhibits Nos. X3405 and X3420.

[531] Id., at 22197–213

[532] This is treated more fully supra, pp. 2150–2160.

[533] See Ch. II of this part or the report, pp. 497 et seq. The following is a summary of losses in affiliates (id., Commission's Exhibits Nos. X3405 [p. 143] and X3421 [pp. 64–5]:

Affiliated companies:	*Net loss sustained by group* [a]
Aeronautical Industries	[b] $3, 100. 04
Allied General Corporation	1, 935, 759. 66
Bond & Goodwin	404, 111. 75
General Investment Corporation (Formerly Public Utility Holding Corporation of America)	6, 573, 977. 27
Hydro Electric Securities Corporation	2, 035, 577. 09
Inland Utilities, Inc	[b] 126, 585, 35
Insuranshares and General Management Co	924, 489. 29
Insuranshares Certificates, Inc	134, 401. 75
Insuranshares Corporation of Delaware	2, 428, 519. 54
International Mtge. & Investment Corporation	[c] 1, 236. 75
International and General Corporation	437, 495. 91
National Aviation Corporation	1, 122, 918. 91
North and South American Corporation	1, 310, 367. 41
Standard Gas & Electric Company	212, 882. 60
Standard Power and Light Corporation	1, 238, 231. 70
Seaboard Investment Trust	[b] 84, 700. 00

involved certain risks present neither in investments in general portfolio securities nor in investments in subsidiaries. Investments in affiliates involved unmarketable holdings without the opportunity for independent management by the group. It is probable that a substantial part of the purchase of securities of affiliates from cosponsors at premiums beyond asset value were made to increase the influence of the group in the affairs of the affiliates. And, finally, the investments in affiliates were subject to the risk of the affiliates' investments in securities of poor quality acquired from other sponsors actively managing the several affiliates. The following illustrations will serve to demonstrate some of the problems presented by the affiliation of the group with other enterprises.[534]

a. United States Electric Power Corporation

The United Founders Corporation group's largest single investment in an affiliate was made in sponsoring and ultimately acquiring control of United States Electric Power Corporation.[535] On September 10, 1929, the United Founders Corporation participated in the formation of United States Electric Power Corporation, a Maryland Corporation.[536] The other participants were Victor Emanuel, Hydro-Electric Securities Corporation, Thomas A. O'Hara, W. C. Langley & Company, Seaboard National Corporation, A. C. Allyn & Company, and The Harris Forbes Corporation.[537] Of the $133,643,949 capital raised by the United States Electric Power Corporation during 1929 and 1930, the United Founders Corporation paid in or raised through its distributing organization a total of $73,804,964.[538] On November 30, 1929, the United Founders Corporation group held 700,000 shares of Class A common stock, 2,175,383 shares of common stock and 10,000 shares of preferred stock at an aggregate cost of $57,485,175.34, having a paid-in value of $42,446,116.53 or a cost of $15,039,058.51 in excess of the paid-in value.[539]

During 1930, the investment of the United Founders Corporation group was increased to $79,270,885.14.[540] Of this increase, a substan-

Sterling Securities Corporation	115, 659. 67
United National Corporation	6, 013, 237. 01
United States and Overseas Corporation	[b] 1, 302, 230. 92
United States Electric Power Corporation	74, 133, 890. 30
Washington and Suburban Companies	964, 081. 51
Westfield Trust	[b] 66, 068. 65
Winslow Lanier International Co	158, 597. 55
Total	98, 562, 750. 71

[a] Includes the losses of Founders General Corporation as a subsidiary.
[b] Denotes net profits.
[c] Company denies affiliation.

[534] For the sake of brevity, no discussion of the investment of the United Founders Corporation group in General Investment Corporation is presented herein, since the history of that affiliate is set forth in some detail in Ch. II of this part of the report, pp. 497 et seq.

[535] A detailed discussion of the United States Electric Power Corporation is set forth in Part Four of this report.

[536] Op. cit. supra, note 1, Commission's Exhibit No. X4019.

[537] Id., Commission's Exhibits Nos. X4023 and X4025.

[538] Id., Commission's Exhibit No. X3422 (p. 9). United States Electric Power Corporation issued 2,000,000 shares of Class A common stock, 6,580,720 shares of comon stock, and 177,500 shares of $6 cumulative dividend preferred stock for $138,531,449 and disbursed $4,887,500 in retirement of preferred stock. (Ibid.)

[539] Id., Commission's Exhibit No. X3422 (pp. 15, 16, 18, and 20).

[540] Id., Commission's Exhibit No. X4086.

tial part was the result of the activity of the group in raising additional money for the affiliate,[541] and the principal part of the balance was the purchase of the interests of co-sponsors [542] in order to secure control of the affiliate.[543]

By the end of 1935, the investment in United States Electric Power Corporation had depreciated to a negligible value; on this investment the United Founders Corporation group sustained a net loss of $70,668,650.81.[544] At that time the affiliate had bank loans in default in excess of its assets, all of which were pledged to secure the obligations.[545]

Perhaps more than any other affiliation of the group, United States Electric Power Corporation demonstrates the excessive costs of control.[546] The ultimate failure of United States Electric Power Corporation resulted from obligations incurred in attempting to oust predecessor interests in the Standard Gas and Electric Company utility system, and the high cost of its investment in that system accumulated during a fight for control of the system between some of the sponsors of United States Electric Power Corporation and the sponsor of Standard Gas and Electric Company. Similarly, the losses of the United Founders Corporation group were enlarged by reason of an attempt to dominate the sponsorship of United States Electric Power Corporation. Despite the fact that it raised the major part of the capital of that affiliate, the United Founders Corporation group tied itself down to a position of joint control with Hydro-Electric Securities Corporation by a voting agreement executed in September 1929.[547] In order to strengthen its position, the group then made an investment aggregating $11,498,783.84 in the stocks of Hydro-Electric Securities Corporation and of its parent, International Holding and Investing Company, incurring thereby a loss of $10,312,700.30.[548] In addition, as previously noted, during 1930 the United Founders Corporation group bought a substantial part of the interest of the remaining sponsors in United States Electric Power Corporation at a cost of $6,312,098.50.[549]

b. United National Corporation

The United Founders Corporation group sustained one of its substantial losses by investing approximately $6,366,000 in the stock of United National Corporation which was sold at a loss of $6,013,-

[541] In December 1929 the group paid into the affiliate an additional $6,912,322.36 (id., Commission's Exhibits Nos. X3914 and X4069) and in May and June 1930 the group paid in an additional $2,800,000. (Id., Commission's Exhibit No. X3422 [p. 9].)

[542] In the latter part of 1930 cash and securities worth $6,312,098.50 were paid to co-sponsors and their affiliated interests and to officers of the United Founders Corporation group. (Id., Commission's Exhibit No. X4083.)

[543] Id., Commission's Exhibit No. X4082.

[544] Id., Commissions Exhibit No. X3421 (pp. 64–5). This loss was exclusive of about $15,000,000 sustained by stockholders of the group who exercised rights issued to them by companies of the group. (Id., at 26444.)

[545] See Part Four of this report. The bulk of the investment was distributed to the stockholders of United Founders Corporation. (Op. cit. supra, note 1, at 26441–2 and Commission's Exhibits Nos. X3422 [pp. 9, 14] and X4087.)

[546] See Part Four of this report.

[547] Op. cit. supra, note 1, Commission's Exhibit No. X4023.

[548] Id., at 26567 and Commission's Exhibits Nos. X3833 (pp. 18 and 19), X4153, X4154, X4155, X4156, and X4159.

[549] See note 542, supra.

237.01.[550] In June 1929 when the group first invested in United National Corporation [551] the latter was a holding company for real estate, investment banking, investment company, and insurance enterprises operating on the West Coast, particularly in the region of Seattle and Tacoma.[552]

Including the interest that the United Founders Corporation group acquired in United National Corporation, the latter, by June 30, 1929, had issued net 32.261 shares of common stock for about $798,861.50 and 400,000 shares of participating preference stock for $13,041,128.[553]

Against these outstanding shares were assets of $13,937,926.50 or approximately $32.25 per share.[554] The United Founders Corporation group acquired initially 10,754 shares of the common stock and 75,000 shares of the participating preference stock at a cost of $2,781,350, or approximately the book value.[555] At the time of purchase two-thirds of the common stock purchased was deposited with two-thirds of the remaining common stock under a voting trust agreement in which the group selected one trustee and the other sponsors of United National Corporation selected two trustees.[556]

During the balance of the year 1929, the United Founders Corporation group acquired an additional 50,000 shares of United National Corporation stock at a cost of $2,137,902.07 thereby increasing its aggregate investment in United National Corporation to $4,919,-252.07.[557] In November 1930, the investment of the United Founders Corporation group in United National Corporation was further increased as the result of an agreement between Founders General Corporation and Drumheller, Ehrlichmann and White, Inc., a sub-

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[550] Id., Commission's Exhibits Nos. X3415 (p. 32), X3421 (p. 61), and see note 533, supra.

[551] Id., Commission's Exhibits Nos. X4195–L, X4198, and X4199.

[552] Id., at 22111–3. United National Corporation was incorporated on July 10, 1928, in the State of Washington, under the name of United Corporation, the name being changed on June 1, 1929, to avoid confusion with the company of the same name sponsored by J. P. Morgan & Company. (Id., Commission's Exhibits Nos. X4195 and X4196.) Sponsored originally by Roscoe M. Drumheller and Ben B. Ehrlichmann, of Seattle, and W. H. White, of Portland (id., Commission's Exhibit No. X4195 [p. 3]) it acquired from them, Drumheller, Ehrlichmann, and White, Inc., an investment banking enterprise. (Id., Commission's Exhibit No. X4195 (L and M).) Shortly thereafter, United National Corporation also acquired Murphy Favre & Company, a security distributing concern operating in Spokane and Portland. (Id., Commission's Exhibit No. X4197.) These two subsidiaries were the principal distributors of the securities of United National Corporation. (Id., Commission's Exhibit No. X4195. Schedule H.) United National Corporation subsequently acquired a third investment banking concern, Ferris and Hargrove. (Id., at 2211–3.)

[553] Id., Commission's Exhibit No. X4195, Schedule M. The participating preference stock was preferred in liquidation to the extent of $25 per share after which the common stock was to receive $25 per share, the balance being distributed equally among all outstanding shares irrespective of class. Similar preferences existed with respect to dividends which were to be paid at the annual rate of $1 per share for the preferred stock after which the common stock was to receive $1 per share, etc. (Ibid.)

[554] Ibid.

[555] Id., Commission's Exhibits Nos. X4197, X4198, and X4199. Of the purchase price $112,500 was paid to the common stockholders of United National Corporation for a waiver of preemptive rights. (Ibid.)

[556] Id., Commission's Exhibits Nos. X4195 and X4199. As a further inducement to the United Founders Corporation group to participate in United National Corporation, Drumheller, Ehrlichmann and White, Inc., and Murphy Favre & Company, two subsidiaries of United National Corporation, assigned to American Founders Corporation one-third of the benefits to be received under management contracts with investment company subsidiaries of United National Corporation. (Id., Commission's Exhibit No. X4201.)

[557] Id., Commission's Exhibit No. X4202.

sidiary of United National Corporation. By these agreements Drumheller, Ehrlichmann and White, Inc., which had been distributing United Founders Corporation common stock since November 1929,[558] was to continue to distribute United Founders Corporation common stock in return for which Founders General Corporation was to take proportionate amounts of United National Corporation preferred stock subject to an option to repurchase such shares given to Drumheller, Ehrlichmann and White, Inc.[559] Under this arrangement Founders General Corporation sold to Drumheller, Ehrlichmann and White, Inc. 29,372 shares of United Founders Corporation common stock and purchased from Drumheller, Ehrlichmann and White, Inc. 21,526 shares of United National Corporation participating preference stock at a cost of approximately $1,411,000. This investment was increased by other purchases to approximately $6,366,000.[560]

In December 1934 the shares of United National Corporation still held by the group were sold to the issuing company for approximately $250,000, resulting in a net loss on the entire investment of $6,013,000.[561]

The loss sustained by the group in its affiliation with United National Corporation was in part attributable to the excess costs paid by that company for its subsidiaries. For example, on June 30, 1930, of the $13,839,990 paid-in capital of United National Corporation almost $6,619,227.47 represented excess costs of subsidiaries beyond their contributed capital.[562] Consequently, while the United Founders Corporation group was buying the stock of United National Corporation at its reported book value, such purchase involved payment of a substantial premium over the underlying assets.

c. North and South American Corporation

In February 1929, the United Founders Corporation group participated with Baker, Kellogg & Co., Inc., and A. G. Becker & Co., Inc., two investment banking houses,[563] in the formation of North and South American Corporation, a Delaware corporation.[564] The common stock capitalization of the newly formed investment company was in several respects similar to that of the investment companies of the group in that it included two classes of stock, one of which enjoyed preference in liquidation and to noncumulative dividends and the other of which carried control and a participation in dividends entirely disproportionate to its contribution to the capital of the enterprise. In May 1929, the newly formed company issued to

[558] Id., Commission's Exhibit No. X4203.

[559] Id., Commission's Exhibit No. X4204.

[560] Id., Commission's Exhibit No. X4203.

[561] Id., Commission's Exhibits Nos. X4205, X3413 (p. 32), X3421 (p. 61) and see note 533, supra.

[562] Reply to the Commission's questionnaire for United National Corporation, Pt. II. There were no earned surpluses of subsidiaries sufficient to offset such excess cost over paid-in capital of subsidiaries to any appreciable extent. (Ibid.)

[563] Op. cit. supra, note 1, at 26570. Prior to the formation of North and South American Corporation, the group had at times financed the investment banking business of Baker, Kellogg & Co., Inc., and its affiliate, Colombian Investment Corporation (id., Commission's Exhibits Nos. X3792 and X3793) and had participated with Baker, Kellogg & Co., Inc., in underwriting Colombian securities. (Id., Commission's Exhibit No. X3794.)

[564] Id., Commission's Exhibit No. X3799.

its sponsors for public distribution 250,000 shares of Class A common stock at $36 per share, less $3.50 per share selling commission, and 1,000,000 shares of Class B common stock at $1 per share.[565] The Class A stock enjoyed one vote per share, preference on liquidation to the extent of the proceeds of sale and a noncumulative preference in annual dividend payments of $2 per share; the Class B common shares also enjoyed one vote per share and were entitled to annual dividends per share equal to one-fourth the per share distribution on the Class A common stock in excess of $2.[566] As a result of such capitalization, for the contribution of $1,000,000, the sponsors were to have an 80% voting control of the $10,000,000 enterprise and, after the payment of noncumulative dividends on the Class A common stock the sponsors were to receive 50% of the dividends disbursed on both classes of stock.

Apparently, all of the 250,000 Class A common stock underwritten by the syndicate [567] were not distributed publicly. As compared to its one-third interest in the syndicate amounting to 83,333⅓ shares, the United Founders group alone had 19,280 shares at a cost of $575,345.62 when the syndicate terminated in December 1929. Of this 10,000 shares were purchased in July and 1,000 shares were purchased in December of 1929 from A. G. Becker & Co., and 6,520 shares were taken over from the syndicate in November and December of the same year at a cost of $194,355.00.[568]

In spite of the break in the stock market late in 1929, American Founders Corporation almost doubled its investment in this affiliate,[569] principally by purchasing the interest of Baker, Kellogg & Co., Inc., in December 1930.[570] At that time $267,639.50 was paid for Class B

[565] Id., Commission's Exhibit No. X3795. Of the 1,000,000 Class B common shares, 105,000 were held by the sponsors for investment by the officers of the investment company, 100,000 were acquired in equal thirds without restriction, and the remaining 795,000 shares were held in equal thirds subject to restrictions on resale (Ibid.) A. G. Becker & Co., Inc., assigned its entire interest in the Class B common shares to its affiliated investment company, Domestic and Foreign Investors Corporation. (Ibid.)

[566] Keane's *Manual of Investment Trusts and Investment Companies* (1930).

[567] On May 14, 1929, American Founders Corporation, A. G. Becker & Co., Inc., and Baker, Kellogg & Co., Inc., entered into a syndicate agreement covering the 250,000 shares of Class A common stock which they had underwritten. The agreement designated the latter two sponsors as syndicate managers. (Id., Commission's Exhibit No. X3795 [pp. 4 and 5].)

[568] Id., Commission's Exhibit No. X3797.

[569] Ibid.

[570] On December 12, 1930, Founders General Corporation entered into a contract with Baker, Kellogg and Co., Inc., and National and Foreign Investing Corporation, by the terms of which National and Foreign Investing Corporation sold to Founders General Corporation 4,976 shares of North and South American Corporation Class A common stock and a note of Baker, Kellogg & Co., Inc., dated August 15, 1930, in the sum of $300,000 against payment by 34,956 shares of United Founders Corporation common stock. National and Foreign Investing Corporation agreed not to resell the United Founders Corporation common stock in the open market in amounts in excess of 5,000 shares until January 1931, and thereafter not to sell in the open market more than 500 shares a day or more than 1,000 shares a week during the year 1931. By the terms of the same contract, Baker, Kellogg & Co., Inc., sold to Founders General Corporation 299,800 shares of North and South American Class B common stock which was paid for with the Baker, Kellogg & Co., Inc., note for $300,000. Founders General Corporation also agreed to buy on or before January 1, 1931, an additional 15,000 shares of North and South American Corporation Class B common stock from persons designated by Baker, Kellogg & Co., Inc., at $1.00 per share, payable in United Founders Corporation common stock, at the rate of one share of United Founders Corporation stock for each 10 shares of North and South American Class B common stock. (Id., Commission's Exhibit

common stock of the affiliate [571] which was dèvoid of any asset value.[572]

The losses of the United Founders Corporation group on its investment in North and South American Corporation were, in part, the result of the management of the affiliate by the co-sponsors. North and South American Corporation was formed primarily for the purpose of investing in South American securities.[573] Most of these South American investments originated in Colombia and were held through a subsidiary, Colombian Investment Corporation,[574] which North and South American Corporation acquired from Baker, Kellogg & Co., Inc.[575] In all, an aggregate of $3,822,031 was invested in or loaned to Colombian Investment Corporation [576] against which reserves against loss of $3,250,000 had been established by March 1932 reflecting depreciation of that amount in the value of the investment.[577] Of the remaining $5,303,000 resources raised, $577,050 had been disbursed in the repurchase of 86,750 shares of its own Class A common stock by March 1932.[578] All but $400,000 of the entire paid-in capital was lost in investments,[579] the losses being to some extent accelerated by bank loans.[580]

The group ultimately disposed of its investment at a loss of $1,310,367,[581] but in doing so involved itself in expensive and protracted litigation by reason of the irresponsible sponsorship which it substituted for itself.[582]

d. Aeronautical Industries, Inc., and National Aviation Corporation

The United Founders Corporation group had a peak investment of $1,654,097 in Aeronautical Industries, Inc., and National Aviation Corporation and lost on this investment $1,119,818.[583] On July 24, 1929, United Founders Corporation became a participant in a trading account in Aeronautical Industries, Inc., common stock, the account being managed by G. M-P. Murphy & Co., Inc., for the joint account and equal participation of United Founders Corporation, James C. Willson & Co., and itself.[584] At the time James C. Willson & Co. and G. M-P. Murphy & Co. were sponsors of Aeronautical Industries, Inc.[585]

No. X3798.) Pursuant to this contract, Founders General Corporation acquired 14,976 North and South American Corporation Class A common shares at a recorded cost of $42,296 and 314,916 Class B common shares at a recorded cost of $267,639.50. (Id., Commission's Exhibit No. X3797.)

[571] Id., Commission's Exhibit No. X3797.

[572] Poor's *Governments, Municipals, Banks, etc.* (1931).

[573] Op. cit. supra, note 1, at 22110–1.

[574] Ibid.

[575] Id., at 26573.

[576] Id., Commission's Exhibit No. X3796 (p. 1).

[577] Ibid.

[578] Id., Commission's Exhibit No. X3769 (pp. 8 and 10).

[579] Stenographer's Minutes, *Benedict* v. *Seagrave et al.*, Supreme Court of the State New York, New York County Special Term, Part III, County Clerk's Index No. 45607–1933 at 585–6.

[580] Op. cit. supra, note 1, Commission's Exhibits Nos. X3799 and X3800.

[581] See note 533, supra.

[582] The details of sale and gravamen of the suit of *Benedict* v. *Seagrave* (op. cit. supra, note 579) are set forth in Ch. IV of this part of the report, pp. 1179–92.

[583] See note 533, supra.

[584] Id., Commission's Exhibit No. X3805.

[585] Aeronautical Industries, Inc., had been incorporated in Delaware on May 8, 1928, as an investment company with powers to invest in domestic and foreign enterprises engaged in the different branches of the aeronautic industry, including manufacture of airplanes,

The trading account in the Aeronautical Industries, Inc., capital shares, to be managed by G. M-P. Murphy & Co., Inc., was to run for the ensuing six months; the sole limitation placed upon the discretion of the manager was that the maximum commitment was to be 20,000 shares long and 10,000 shares short.[586] In settlement of this account, at the end of October 1929, United Founders Corporation acquired 6,658 shares Aeronautical Industries, Inc., stock at $22.68 per share for a total of $151,011; in addition, United Founders Corporation purchased from the trading account an additional 6,658 shares for $59,922.[587] Apparently the additional 6,658 shares constituted the interest of James C. Willson & Co., Inc., from whom on December 30, 1929, United Founders Corporation received an assignment of an option entitling it to buy 13,750 shares common from the company at $22.00 per share.[588] In addition, to the purchases by United Founders Corporation as a syndicate member, the United Founders Corporation group on August 14, 1929, subscribed for 25,000 Aeronautical Industries, Inc., shares to be issued by the company at $21.00 per share or $525,000,[589] and also purchased in July 1929, from G. M.-P. Murphy & Co., Inc., 15,000 shares at $21.00 per share or $315,000.[590] The United Founders Corporation group also acquired in the open market 3,100 shares at a cost of approximately $44,000 and 24,800 of the $30.00 warrants at a cost of approximately $101,000.[591] Thus by January 1930 the aggregate

motors, instruments and accessories, transportation of passengers, mail and express, development of airports, and such other phases of the industry as might prove feasible; the authorized capital consisted of 500,000 shares of stock without par value. The original sponsors of the company were Lester D. Gardner, governor of the Aeronautical Chamber of Commerce of America; Benjamin F. Castle, the general manager of First Federal Foreign Investment Trust and treasurer of the New York Aeronautic Association; and William W. Townsend, of the investment banking concern of W. W. Townsend & Co., Inc. (Keane's *Manual of Investment Trusts and Investment Companies*, 1930.) The original issue of securities occurred in June 1928, when W. W. Townsend & Co., Inc., underwrote an issue of 60,000 shares, accompanied by an equal number of "A" warrants (entitling the holder thereof to purchase an additional share on or before April 30, 1933, at $30.00 per share for each share held) at $20.00 per share less $2 per share commission. W. W. Townsend & Co., Inc., was to receive any excess in selling price over $20 per share and was also to receive $2.00 for each share issued in exercise of the "A" warrants. (Op. cit. supra, note 1, Commission's Exhibit No. X3804.) On February 16, 1929, G. M-P Murphy & Co., Inc., Aeronautical Industries, Inc., and W. W. Townsend & Co., Inc., entered into a new agreement with respect to the sponsorship of Aeronautical Industries, Inc. The board of directors was reduced from twelve to eleven, seven to be designated by G. M-P Murphy & Co., Inc., and the remaining four to be Messrs. Gardner, Castle, and Townsend, and Louis F. Reed, of Reed and Bassford. G. M-P Murphy & Co., Inc., agreed to underwrite for delivery on or before April 15, 1929, an additional 40,000 shares of stock with warrants at $20.00 per share, less $2.00 per share commission. G. M-P Murphy & Co., Inc., was entitled to any excess in the sales price beyond $20.00 per share and was also to receive $2.00 per share on the exercise of the 40,000 warrants accompanying the shares underwritten. The company also issued to G. M-P Murphy & Co., Inc., an option to buy on or before April 30, 1933, 120,000 shares of stock at $22.00 per share. G. M-P Murphy and Co. assigned to Messrs. Gardner and Townsend options to buy 18,000 Aeronautical Industries, Inc., shares apiece. (Ibid.) This agreement was apparently made by G. M-P Murphy & Co., Inc., on behalf of itself and the investment banking houses of James C. Willson and Co., Inc., and Blair and Co., Inc., both of whom were accorded representation on the board of directors. (Keane's *Manual of Investment Trusts and Investment Companies*, 1929.)

[586] Op. cit. supra, note 1, Commission's Exhibit No. X3805.

[587] Id., Commission's Exhibit No. X3806.

[588] Id., Commission's Exhibit No. X3807.

[589] Id., Commission's Exhibit No. X3808.

[590] Id., Commission's Exhibit No. X3806.

[591] Id., Commission's Exhibits Nos. X3806, X3807, X3808, and X3809.

investment of the United Founders Corporation group in Aeronautical Industries, Inc., amounted to approximately $1,224,000 [592] and included 56,416 shares or 45.13% of the 125,000 shares outstanding at that time.[593] Needless to say, the quality of this investment was limited by reason of outstanding warrants and options to buy over twice as many shares of stock as were outstanding.

In February 1930 National Aviation Corporation, which had been formed by James C. Willson & Co. and G. M.-P. Murphy & Co., Inc., in New York on June 23, 1928, with an authorized capitalization of 500,000 shares of no-par stock and with powers and purposes also substantially the same as those of Aeronautical Industries, Inc.,[594] offered its common shares, warrants, and options for the common shares, warrants, and options of Aeronautical Industries, Inc., on the following terms: for each four shares of Aeronautical Industries, Inc., common stock, three shares of National Aviation common stock; for each four $22.00 option warrants, three $22.00 option warrants exercisable on or before the same date; for each four $30.00 warrants, three $30.00 warrants exercisable on or before the same date, and this exchange was accepted by the United Founders Corporation group.[595] The group received in the exchange 42,312 shares of National Aviation Corporation common stock.[596] In addition to the shares of National Aviation Corporation received in the exchange, during the year ending November 30, 1930, the United Founders Corporation group acquired an additional 27,100 shares of common stock for $423,700, and sold 1,500 shares for $66,690, which increased its aggregate holdings to 69,412 shares [597] or approximately 21% of the 323,277 shares outstanding on December 31, 1930.[598]

On August 2, 1932, G. M.-P. Murphy & Co., Inc., offered to buy the United Founders Corporation group holdings of National Aviation Corporation. The offer was accepted, and these shares, costing $1,525,190.25 were sold for net proceeds of $283,193.04, or at a loss of $1,242,000.21.[599] Subsequently, in April 1933, the warrants and options expired, involving a further loss to the group of $113,919.60,[600] increasing the aggregate loss to $1,356,000. Profits on sales during the fiscal years 1928 and 1929 reduced the net loss sustained by the group on the securities of National Aviation Corporation and Aeronautical Industries, Inc., to $1,119,818, on an investment of $1,654,097.[601]

4. GENERAL PORTFOLIO INVESTMENTS

Although the companies of the United Founders Corporation group invested in general portfolio securities at one time or another, only four of the five underlying investment companies, International Securities Corporation of America, Second International Securities Corporation,

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592 Ibid.

593 Keane's *Manual of Investment Trusts and Investment Companies* (1930), p. 1458.

594 Id., p. 1456.

595 Op. cit. supra, note 1, Commission's Exhibit No. X3811.

596 Id., Commission's Exhibit No. X3813.

597 Ibid.

598 Keane's *Manual of Investment Trusts and Investment Companies* (1931), p. 391.

599 Op. cit. supra, note 1, Commission's Exhibit No. X3814.

600 Ibid.

601 Id., Commission's Exhibit No. X3813, and see note 533, supra.

United States & British International Company, Ltd., and American & General Securities Corporation, made such investments as a matter of constant investment policy.[602] The investment policies of these four companies were limited by elaborate investment restrictions embodied in their bylaws restricting the maximum investments in any one country, in any one type of enterprise, in newly formed companies, and in promotions or underwritings, etc.[603] Subsequently the investment restrictions were found to be too inelastic.[604] However, with the exception of American & General Securities Corporation, the companies were unable to abandon their investment restrictions even by vote of the stockholders because such restrictions had been incorporated as covenants in the indentures securing the debentures which the companies had issued.[605]

However, the principal difficulties of the investment companies of the group were not so much the result of inelasticity of their investment restrictions as the handicap imposed by the complex capital structure. Faced with the problem of earning on the capital paid in for senior securities an amount necessary to meet the incidental management and interest expenses and preferred dividend requirements, the companies of the group, during 1927 and 1928, invested heavily in high-yield foreign bonds. The foreign holdings constituted well over one-half of the available resources of the group,[606] and tended to concentrate in those countries which lacked stability of economic conditions and in which the interest rates were higher than in other countries having more stable economic conditions.[607] While this policy was consistent withthe theory of international diversification enunciated by the group,[608] ultimately the group had considerable difficulty withdrawing the funds from the countries in which it had its most substantial foreign investments.[609]

During 1929 the problem of meeting the cost of senior financing (interest, dividends, and discounts) was met to a substantial extent by trading in domestic stocks.[610] With the exception of but $40,000,000, the new capital raised by the group was invested domestically.[611] Such investments were not always made in readily marketable blocks of securities. For example, the group invested $1,000,000 in buying 10% of the stock of the newly created International Mining Corpora-

[602] As previously pointed out, American and Continental Corporation was largely engaged in lending foreign credits and the principal investments of United Founders Corporation, American Founders Corporation, Investment Trust Associates, and Founders Associates were in the securities of companies of the group and their affiliates.

[603] Op. cit. supra, note 1, Commission's Exhibits Nos. X3425 (pp. 12–13), X3425A (pp. 15–16), X3426 (pp. 15–16), X3406–C (pp. 7–10), and X3408–C (p. 7).

[604] Id., at 22962–5.

[605] Id., Commission's Exhibits Nos. X3401–G–1, X3406, and X3408. American and Continental Corporation covenanted with the trustee of its debentures to maintain $11,250,000 of its assets in cash, credits, notes, or bonds rather than stocks. (Id., Commission's Exhibit No. X3747–A.)

[606] Id., Commission's Exhibits Nos. X3424–D and X3424–E.

[607] Id., at 22935 and 22941–3.

[608] Id., at 22947.

[609] The largest single foreign investment was in Germany, in which it had difficulty withdrawing funds because of restrictions imposed by the government. (Id., at 22930–2.)

[610] Id., at 24879–80 and 24869.

[611] Id., at 22941 and Commission's Exhibits Nos. X3424–B and X3424–E. To some extent there were also substantial liquidations of foreign investments and purchases in the domestic market during October and November 1929, after the stock market break. (Id., at 22939.)

tion.[612] On this investment the group ultimately sustained losses of $775,000.[613]

The five investment company subsidiaries of American Founders Corporation had invested their resources in the following categories at November 30, 1929:[614]

Call loans		$5,550,000.00
General portfolio:		
Domestic bonds	$5,745,608.58	
Domestic stocks	36,097,283.10	
Intermediate credits	490,382.50	
Foreign bonds and credits	61,013,068.02	
Foreign stocks	28,803,612.15	
Total general portfolio		132,149,954.35
Investment in stocks of affiliates		6,182,427.76

At that time, they had already sustained on their general portfolio an unrealized loss in value of $19,847,700.05, or approximately 15% of the cost thereof.[615] The five investment companies, by the end of November 1935, sustained on their general portfolios, $85,202,187.66 aggregate losses, constituting the largest single element in their $54,392,418.06 aggregate net loss from investment operations.[616]

5. TRADING IN SECURITIES OF AFFILIATES

One of the weaknesses of the several companies of the United Founders Corporation group was the constant departure from the announced policies of management. For example, during 1927 and 1928, the management of the group advertised that Second International Securities Corporation invested its funds with the advice of American Founders Corporation, which advice was in turn formulated from analysis of data material to the formulation of expert judgment.[617] However, contrary to the announced activities of the company,[618] a small part of the resources of Second International

[612] Id., Commission's Exhibit No. X4152.

[613] These losses were realized as follows (id., Commission's Exhibits Nos. X3421 [p. 69], X3405 [p. 138], X3407 [p. 142], X3409 [p. 11], and X3411 [p. 73]):

United Founders Corporation	$542,500
American Founders Corporation	139,500
Second International Securities Corporation	31,000
United States & British International Co., Ltd	31,000
American & General Securities Corporation	31,000

[614] Id., Commission's Exhibit No. X3424–B.

[615] The market value of the general portfolio had depreciated to $112,302,254.31. (Ibid.)

[616] The investment performance of the five companies was in aggregate as follows (id., Commission's Exhibit No. X3424–J):

Net income—exclusive of profit or loss on sales and write down of investments	$14,346,285.56
Net profit on sale of securities of companies of group	13,726,599.05
Net loss on sale of other investments	83,076,336.61
Net write-downs of investments in affiliates	448,445.44
Net write-downs of general portfolio securities	2,125,851.05
Unrealized appreciation on investments in November 1935	3,185,330.43
Net loss resulting from investment operations	54,392,418.06

[617] Id., at 22904–8.

[618] Ibid.

Securities Corporation was devoted to investment in the securities of its affiliate, International Securities Corporation of America.[619] The investment was marked by repeated sales and repurchases of the Class A common stock of International Securities Corporation of America at advancing prices, and the reinvestment of amounts equal to the original cost plus all the profits realized on the sale of that stock.[620] From these transactions approximately 40% of the recorded profits of Second International Securities Corporation, during 1927, was realized.[621] According to Mr. Seagrave, such activity of Second International Securities Corporation constituted "trading rather than long-term investment." Mr. Seagrave testified as follows:[622]

A. It was trading, rather than long term investment.

Q. Well, does that strike you as a sound or healthy position, whereby one company in a group sells to the fiscal agent or through the fiscal agent the securities of another corporation in the group, registers a profit which it puts in its income account and at the end of the time has the securities at a price higher than any figure at which it sold them?

A. But, which it eventually sold out, did it not?

Q. We will take that question up later. I do not know whether it did or not.

A. I would rather not see it done. At the time there was a good deal of discussion about that. Some of the directors thought that they ought to be permitted to invest in International Securities Corporation; it was an older company that they thought a good deal of, they ought to invest some modest proportion of their assets. These transactions indicate that they traded in and out. That particular phase of it I do not approve of very much.

Mr. Seagrave testified the trading was to be regarded as an unsatisfactory activity in view of the fact that the profits were plowed right back into the repurchase of the securities from the sale of which profits had been realized:[623]

Q. What is the fact? Is it not, Mr. Seagrave, that it is somewhat illusory to show on your income account, profits made from a transaction in securities when you purchased those securities immediately afterwards at the highest price that you have been able to sell those securities for in the market?

A. No; I think it is [not] very good trading policy; I think they should have probably waited until they got them cheaper.

Mr. Riggs. Mr. Stern's question was as to whether the profits were illusory. There was not any doubt that the profits were realized, was there?

A. Not a bit.

Q. But you recognize, I take it today, that there is something illusory in holding out as a profit the difference between the price that you have paid for securities and the price that you realized on the sale of those securities if you have bought the securities back after the last sale.

A. Certainly, from an investment policy, that is true; from the trading policy, however, that is just what happens.

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[619] Id., at 22898 and Commission's Exhibit No. X3535. Such trading is distinguishable from the typical transactions of the companies of the group engaged in for intercompany or distributing profits and which, as previously indicated, required at times no outlay of funds and only monetary risk. See the succeeding section of this chapter for details of such transactions.

[620] Ibid.

[621] From these transactions profits of $158,515.76 were realized during 1927 (ibid.), or approximately 40% of all profits realized that year by Second International Securities Corporation from sale of investments. (Id., Commission's Exhibit No. X3407 [p. 129].)

[622] Id., at 22901.

[623] Id., at 22902.

6. ASSUMPTION AND PAYMENT OF DEBTS OF OTHERS

At times, particularly during the earlier years, the departures of the management from the announced policy of activity were made in direct violation of the rights accorded to the security holders by the charters and bylaws or by covenants included in the indentures of the several companies. The transactions hereinafter described illustrate a few of the more flagrant departures of the management from the announced principles governing the uses to which the resources of the investment trust or investment company might properly be devoted.

In retrospect it appears as though at the very start the management of the group contemplated the application of the resources of American Founders Corporation to their own personal advantages or to speculative activities entirely out of keeping with the corporate purposes of American Founders Corporation. Although the sponsors of American Founders Corporation intended that it should finance the organization and other expenses of International Securities Corporation of America, an investment company having at the time an authorized capitalization of over $65,000,000,[624] the sponsors contributed to American Founders Corporation at its inception only $500 in cash.[625]

For this $500 cash contribution and a $2,030 account receivable from Mr. Coombs (who was then in bankruptcy), American Founders Corporation assumed $8,531.69 liabilities of United Investors Service Company, an inactive[626] enterprise in which its sponsors had theretofore been interested.[627] Contrary to the charter,[628] American Founders Corporation issued to the sponsors $5,800 par amount of its first preferred stock, as well as $5,800 par amount of second preferred and common stocks.[629] Even the $500 cash proceeds were not utilized for corporate purposes but were instead, together with the first proceeds of the public sale of the stock of American Founders Corporation, almost immediately loaned to Bridgeport Rolling Mills,[630] an unsuccessful[631] industrial plant in which Mr. Bull was then interested.[632]

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[624] The authorized capitalization of International Securities Trust of America consisted of $40,000,000 face amount debentures, $25,000,000 par amount preferred stock, and 800,000 common shares without par value. (Id., Commission's Exhibit No. X3425–A.) Ultimately International Securities Corporation of America, the corporate successor of International Securities Trust of America, received $63,725,000 net proceeds for the issue of its securities. (Id., Commission's Exhibit No. X3424–C.)

[625] Id., at 22233. Mr. Bull testified that of the sponsors, he himself contributed the $500 cash. (Id., at 22018.)

[626] Id., Commission's Exhibit No. X3432.

[627] Id., at 22019, et seq.

[628] The charter provided that the first preferred stock might not be issued except for cash or property worth the full par value of the stock. (Id., Commission's Exhibit No. X3427.)

[629] Id., Commission's Exhibit No. X3432.

[630] Id., at 22238. The first $1,500 cash proceeds received by American Founders Corporation for issuance of its securities was loaned to Bridgeport Rolling Mills.

[631] Mr. Bull testified (id., at 22036):

"Q. In any event, getting down to bedrock facts, the facts were that you had expended money in the stock of Bridgeport Rolling Mills. Now, Bridgeport Rolling Mills at that time was not a prosperous concern; was it, Mr. Bull?

(Footnotes [631] and [632] continued on p. 2213)

7. LOANS TO SPONSORS AND THEIR OTHER ENTERPRISES

Until October 31, 1924, the funds raised from the public,[633] particularly by American Founders Corporation, were devoted largely to sponsoring enterprises of particular interest to Coombs and Bull and to loans to them personally. Mr. Bull testified regarding the use of American Founders Corporation's resources as follows:[634]

Q. And American Founders was somewhat treated as a family matter up to that time?

A. Yes.

Q. As a matter of fact, about $450,000 of these assets, $450,000 of the tangible assets, had been invested in Bridgeport Rolling Mills, loaned to you, loaned to W. R. Bull and Company, and loaned to Mr. Coombs, is that correct?

A. Yes, that is apparently correct from the records.

American Founders Corporation constantly increased the loans made to Bridgeport Rolling Mills, and although the borrower was able to pay dividends to its stockholders apparently no interest was paid on the loans borrowed other than by increasing the face amount of the notes.[635]

At the same time, loans were made to Mr. Bull personally, payment of interest being deferred by increasing the face amount of the notes,[636] and loans were made to W. R. Bull & Co., Inc., of which Mr. Bull was the sponsor.[637] By October 1924, these loans and investments in the stock of Bridgeport Rolling Mills and W. R. Bull & Co., Inc., aggregated at cost approximately $300,000[638] or 40% of the paid-in capital of American Founders Corporation.[639] These

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"A. Well, I could not say it was a prosperous concern; no. It was holding its own from time to time.

"Q. Had it ever earned any money?

"A. Oh, yes—well, the company was a reorganization in 1918, or 1919, from a plant in Bridgeport. By 1922 I can't say, without going over the old record, whether at that time it had earned any money or not. It has since been a very profitable concern.

"Q. Don't you recall, Mr. Bull, that at no time from 1921 on, until after these loans and investments in Bridgeport Rolling Mills were liquidated, Bridgeport Rolling Mills had operated at a loss every year?

"A. Well, I did not recall it, Mr. Stern. If that is the case, I don't question it.

"Q. You don't question it?

"A. Oh, no."

[632] Id., at 22251.

[633] By October 31, 1924, American Founders Corporation had raised about $824,000 capital (id., Commission's Exhibits Nos. X3437 and X3438) and International Securities Corporation of America had raised through the efforts of American Founders Corporation $1,329,000 capital resources (id., Commission's Exhibit No. X3400).

[634] Id., at 22026–7.

[635] Id., at 22261–2 and 22245–9. Although Bridgeport Rolling Mills, Inc., was operated at a loss from 1922 until 1925 (id., at 22239), it paid dividends uninterruptedly until 1925 (id., Commission's Exhibits Nos. X3492 and X3504). It met the interest payments due on its notes to American Founders Corporation by periodically increasing the amount of the notes. (Id., at 22245–9.) By 1925 the loans from American Founders Corporation were determined to be uncollectible (id., Commission's Exhibit No. X3491), and in the middle of 1925 Bridgeport Rolling Mills was reorganized (id., Commission's Exhibit No. X3507).

[636] Id., at 22250.

[637] Id., at 22245–6.

[638] Id., Commission's Exhibit No. X3461.

[639] See note 633, supra.

loans and investments were of particular advantage to Mr. Bull, although of questionable advisability for the investment company. Mr. Bull testified:[640]

Q. Now, Mr. Bull, among the advantages received by you and your company out of your connection with American Founders Trust were these: that you could purchase stock or at least did purchase stock on credit, that is, giving your note for it; that advances were made to the Bridgeport Rolling Mills, a concern in which you were interested; that concern was to pay interest but didn't pay it. The interest was finally cleaned up in your settlement with the company; that W. R. Bull and Company stock was sold to Founders; and that at the time W. R. Bull and Company's stock was sold to Founders, W. R. Bull was getting whatever increase in business it got at that time through its connection with Founders. Isn't that correct, as I have stated it?

A. That is correct, except the last statement. W. R. Bull and Company was doing a growing, genuine investment business. Its business wasn't by any means confined to Founders, you know.

* * * * * * *

Q. Well, my question was that one of the advantages that came to you was that stock of W. R. Bull and Company was purchased by American Founders Trust with the moneys that that trust had raised.

A. Yes.

Q. And this enabled Bull and Company to expand its business; that at the time we showed you yesterday, in 1922, W. R. Bull and Company had at the beginning of the year a capital of $10,000.

A. [Yes] (The witness nodded affirmatively.)

Q. Then, in addition to these advantages that you got there was your compensation for services as manager of the trust; that W. R. Bull and Company received commissions, including an over-writing commission, it received the loans and also its investment in it, which gave it working capital, and that this increased its good will and its orders. Those were the advantages that were received by you and your organization in connection with American Founders. Now, as you look back upon it, Mr. Bull, does it seem to you to have been a good thing to have employed the moneys of Founders Trust in investing in a concern like Bridgeport Rolling Mills, that had been running steadily at a loss?

A. Well, of course, in looking back I would question the advisability of it somewhat. But I think to get any fair picture we must take the circumstances as of that time.

The loans to insiders were particularly questionable because the stock of American Founders Corporation was currently being distributed publicly by its sponsors as the securities of a conservative management company. In the distribution of the stock stress was placed upon the invested interest of American Founders Corporation in International Securities Corporation of America,[641] an investment trust which in turn advertised its own conservative operations,[642] e. g., that it neither engaged in promotions, financings, nor invested in unseasoned securities.[643]

[640] Op. cit. supra, note 1, at 22251–2.
[641] Id., Commission's Exhibit No. X3737 (pp. 37–41).
[642] Id., at 22059.
[643] Id., Commission's Exhibit No. X3451.

Despite the testimony of Mr. Bull that the loans and investments in Bridgeport Rolling Mills and W. R. Bull and Co., Inc., had been made in contemplation of a consolidation with American Founders Corporation,[644] it is apparent from the testimony of Mr. Erwin that neither the stockholders nor the board of directors nor Mr. Bull's fellow sponsors of American Founders Corporation were aware of the use to which the funds had been directed. In this respect, Mr. Erwin testified:[645]

A. Well, I think as near as I can recall, Mr. Coombs was not aware of the amount of this obligation of Mr. Bull's until along about a few weeks perhaps preceding this agreement, and that is when he told me about it, and I know that we were both very much disturbed until we could get some kind of a plan worked out.

* * * * * * *

Q. And part of your difficulty was, Mr. Erwin, you had not known about that up to that time and you had sold units of this Corporation?

A. I had, and was very much concerned, and I know that Mr. Coombs was also.

Q. Surprised as well, were you not?

A. Well, it was like a bombshell, so far as I was concerned.

By March 1925, the loans to Mr. Bull and companies in which he was interested, amounting to $300,000, were found to be uncollectible.[646] A plan of securing the obligations was adopted by the terms of which Mr. Bull was to substitute for these obligations his own notes in an aggregate amount of $300,000 secured by such common shares of the investment company's own stock as Mr. Bull had theretofore received and might thereafter receive for his services as manager of the investment company, at a stipulated value per share.[647] The settlement contract absolved Mr. Bull of any personal liability on his notes for any deficiency that might result in the sale of the collateral securing the notes.[648]

In November 1925, American Founders Corporation finally disposed of the $300,000 of loans and investments[649] to Mr. Bull, in return for 12,000 shares of its own stock at $25 a share.[650] This price was about 35% higher than the current book value of $18.50 a share and fifteen times the price at which the shares had been issued to Mr. Bull for his services.[651]

The $300,000 obligations just discussed were not the sole loans to insiders during 1924. As of October 29, 1924, apart from $278,602.55 loans to and investments in W. R. Bull & Co., Inc., and Bridgeport Rolling Mills, American Founders Corporation held $102,258.38 balances due on notes and accounts receivable from Mr. Coombs and Mr. Bull.[652] And these balances of $102,258.38 were in turn only part of

[644] Id., at 22251 and 22026–7.

[645] Id., Commission's Exhibit No. X3737 (pp. 22–32).

[646] Id., at 22038.

[647] Id., at 22049–52 and Commission's Exhibit No. X3491.

[648] Ibid.

[649] Id., at 22052.

[650] Id., at 22272 and Commission's Exhibit No. X3505.

[651] Id., Commission's Exhibit No. X3402. This price was only one-half the current market price maintained by the company. (Id., at 22278, 22301–7 and 22318–9.)

[652] Id., Commission's Exhibit No. X3468.

the loans theretofore made to the insiders by the company. During June 1924, Mr. Coombs and Mr. Bull had settled $166,735 obligations to American Founders Corporation by the sale to it of stock previously issued to them on credit.[653]

8. SHORT SALES OPERATIONS OF AMERICAN FOUNDERS CORPORATION

In 1924 and 1925, at the same time that funds of American Founders Corporation were used to finance Mr. Bull and two enterprises in which he was interested, the management of American Founders Corporation was devoting a substantial part of the investment company's remaining assets, as well as a substantial part of the assets of International Securities Corporation of America, to "speculative" purposes—the "short" sale of securities.[654] The management was aware[655] that the charter of American Founders Corporation did not empower short sales.[656] Nevertheless, contrary to the spirit of its organization and contrary to any understanding that the investors might have respecting the nature of the company's business by reason of the advertised conservative standards of business, and without informing the stockholders, American Founders Corporation opened margin accounts with brokers, through which short sales were made for the account of that company, in anticipation of a decline in security prices.[657]

By November 30, 1925, the balance of securities sold "short" for the account of American Founders Corporation amounted to $1,326,-323.50,[658] or over 30% of the then $4,000,000 paid-in capital and surplus.[659]

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[653] Id., at 22054, 22251–2, 22301–2 and Commission's Exhibit No. X3439. As of November 30, 1925, in spite of the settlement of $300,000 loans to Mr. Bull., American Founders Corporation still had $480,000 outstanding loans to insiders (id., Commission's Exhibit No. X3462–B and C) and at the end of November 1926 insiders still owed American Founders Corporation $216,000 (id., Commission's Exhibit No. X3464).

[654] Id., at 22551. A "short" sale is a sale of securities which are not owned but which the seller contemplates purchasing subsequently at a price less than the sales price.

[655] Id., at 22342.

[656] Id., at 22345 and Commission's Exhibits Nos. X3427 and X3520.

[657] Id., at 22343–7, 22269, and 22690. In its published report to stockholders, American Founders Corporation deducted its short sales accounts from the balances in its margin accounts due from brokers (id., at 22423–6), thereby concealing any possible loss from the investor (id., at 22426 and 22579). The senior officers of American Founders Corporation also concealed the short sales activities from the employees of American Founders Corporation by referring to the several "short" sales accounts under the code name "Valpo" or "Valparaiso" (id., at 22042 and 22651–2). With respect to these short sales operations by the managers of investment trusts (American Founders Corporation was at the time manager of International Securities Corporation of America), Mr. Bull testified (id., at 22343–) :

"Q. What would your comment today be on the manager of a trust starting a short account?

* * * * * * *

"A. I do not think it was a wise thing to do. I readily admit that. * * *"

[658] Id., Commission's Exhibit No. X3462. This figure is merely the balance of securities sold short at the sale price thereof. It does not reflect short sales previously closed out by purchases, nor the possible unrealized loss and equivalent increase in the liability for securities sold short resulting from increased market price of unowned securities sold and yet to be purchased to fulfill delivery.

[659] Ibid.

Although the management effected the short sales only for the account and benefit of American Founders Corporation, the assets of International Securities Corporation of America were also used by them to finance this speculative activity. Both the cash and the portfolio securities of that investment trust were commingled with the assets of American Founders Corporation. As early as September 1923, the necessity of segregating the assets of the two investment trusts was impressed upon the management.[660] Nevertheless, commingling of the assets continued until 1926.[661] By October 31, 1924, American Founders Corporation had used $215,460.50 of the portfolio securities of International Securities Corporation of America in its possession as collateral to secure its own short sales accounts.[662]

The participation of International Securities Corporation of America in the speculations of American Founders Corporation is particularly significant in view of the fact that American Founders Corporation had distributed the securities of the former company to the public upon the representations that International Securities Corporation of America was "conservatively" operated.[663]

In January 1926, Royal E. T. Riggs, counsel for the American Founders Corporation, criticized the "short" sales as illegal and beyond the powers of the investment company, and the commingling of the assets of the two investment trusts as improper.[664] The management, in the dual capacity of the ones surchargeable for losses from the "short" sales and of the sole members of the executive committee of American Founders Corporation, which conducted the negotiations

[660] Id., at 22335.

[661] Id., at 22335. As of November 30, 1924, American Founders Corporation held possession of all assets of International Securities Corporation of America other than those assets pledged to secure the outstanding collateral trust bonds of International Securities Corporation of America. (Id., Commission's Exhibit No. X3453.) According to the records of International Securities Corporation of America, American Founders Corporation held the assets separately in the capacity of an agent (ibid., and Commission's Exhibit No. X3457), and consequently as a bailee. However, the records of American Founders Corporation treat the cash held as an account payable (id., at 22352 and Commission's Exhibit No. X3461), and the securities were apparently also treated as borrowed. In other words, American Founders Corporation treated International Securities Corporation of America as a general and not as a preferred creditor. By November 30, 1925, American Founders Corporation had paid $178,000 interest to International Securities Corporation of America at the rate of 8% per annum on the cash deposited with it (id., at 22540–2), indicating average cash deposits of approximately a million dollars for the past two and one-half years. At that time American Founders Corporation had possession of all the $2,397,778.69 unpledged assets of International Securities Corporation of America not required for current interest and dividend payments. (Id., Commission's Exhibit No. X3457 [p. 6].) The diversion of assets of International Securities Corporation of America from investment purposes was not limited to the appropriation by American Founders Corporation of a commingled fund for speculative purposes. An aggregate of $2,672,915 of the resources of International Securities Corporation of America were used, in August 1926, to repurchase its own preferred and common shares from American Founders Corporation when the latter company found the securities unmarketable (id., at 22754–5, 22760, and Commission's Exhibits Nos. X3527 and X3528). Apart from the reduction of the protection to the holders of senior securities (id., at 22760), the transaction was objectionable because of the conflicting interests between the stockholders of International Securities Corporation of American and of American Founders Corporation. (Id., at 22761.)

[662] Id., at 22040–3 and Commission's Exhibit No. X3461. These accounts were also used to buy and sell investments of International Securities Corporation of America. (Ibid.)

[663] Id., at 22685 and Commission's Exhibit No. X3451. Although after the commingling of assets terminated the stockholders of International Securities Corporation of America were advised that its assets were segregated, at no time were they advised of the prior commingling. (Id., at 22354.)

[664] Id., Commission's Exhibit No. X3520.

on its behalf,[665] then arranged to take over personally the "short" account.[666] On June 26, 1926, Investment Trust Associates, a personal holding company for Mr. Coombs,[667] agreed with American Founders Corporation to take over the "short" position on behalf of Messrs. Coombs, Erwin, Bull, and Seagrave in the following proportions:[668] Mr. Coombs, 41.88%; Mr. Bull, 27.60%; Mr. Erwin, 23%; and Mr. Seagrave, 7.52%. American Founders Corporation agreed to lend Investment Trust Associates the necessary cash secured by American Founders Corporation's own common stock.[669] In all, American Founders Corporation loaned Investment Trust Associates $512,000 secured by 25,620 shares of American Founders Corporation's own common stock.[670]

On October 30, 1926, the loan was settled by the payment to American Founders Corporation of $115,000 cash recouped from the "short" accounts with brokers and by the sale to American Founders Corporation of 17,582 shares of the stock theretofore pledged at $23.50 a share for a total of $413,084.88.[671] This exceeded the current asset value of the shares by approximately $190,000.[672]

When the managers finally terminated the short account in the middle of 1927, they had reduced their losses therein through further operations to approximately $200,000 net.[673] However, by continuing a series of transactions with American Founders Corporation in its own stock, the managers recouped the major part of this loss from American Founders Corporation. Between November 30, 1926, and May 7, 1927, pursuant to an "unwritten option,"[674] Investment Trust Associates, on behalf of the managers, repurchased from American Founders Corporation 10,082 shares of its common stock at $23.50 a share[675] for a total of $236,927, or about $146,000 less than the market value of the stock at the time of the several sales to Investment Trust Associates,[676] thus effectively reducing the managers' loss from $200,000 to about $54,000.[677]

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[665] Id., at 22656–60.

[666] Id., at 22607–8. Some tentative agreement was made in April 1926; however, this agreement was not in writing. (Ibid.)

[667] Id., at 22094.

[668] Id., at 22503, 22620 and Commission's Exhibit No. X3769.

[669] Id., at 22617, 22623 and Commission's Exhibit No. X3769.

[670] Id., at 22617 and 22638–9.

[671] Id., at 22617–19, 22649, and 22505–8.

[672] At November 30, 1926, the reported book value of the American Founders Corporation common stock was $12.72 a share. (Id., Commission's Exhibits Nos. X3464 and X3469.)

[673] Mr. Seagrave testified that at that time, for his 7.52% interest he sustained a loss of about $15,099. (Id., at 22663–8.)

[674] Id., at 22627–39 and 22654–5.

[675] Id., at 22627–41.

[676] Ibid.

[677] Mr. Seagrave testified that the officers also took over from American Founders Corporation the stock of Foreign News Distributing Company, which was inappropriate as an investment for American Founders Corporation, and that his own investment and loss therein were respectively $4,500 and $1,500. (Id., at 22094–5.) In addition, in May 1927, Investment Trust Associates, on bahlf of the managers, took over from International Securities Corporation of America what was apparently an ineligible investment in Rm. 700,000 Mitteldeutsche Creditbank shares for $375,000. This purchase was financed by American Founders Corporation lending Investment Trust Associates $380,000 on its note secured by the bank shares, 100 units of International Securities Corporation of America stock, and 1,905 shares Second International Securities Corporation preferred stock. In July the bank

Despite counsel's advice that it was illegal for a Massachusetts trust to engage in "short sales" operations without such a special purpose being included in its charter,[678] in February and March 1929, the management of the group caused Investment Trust Associates, then a publicly owned Massachusetts trust and one of the companies of the group,[679] to sell short approximately $1,000,000 of securities. At the organization of United Founders Corporation, Investment Trust Associates subscribed for 61,000 shares of common stock for $640,500.[680] Between February 16, 1929, and March 9, 1929, Investment Trust Associates sold an aggregate of 103,744 shares of such stock for $2,695,698 [681] which left it "short" on balance 42,744 shares at an average sales price aggregating approximately $1,146,000. The short sales were covered by the purchasing at less than the current market price 42,744 shares of United Founders Corporation common stock from the issuing company at $25.60 a share, resulting in a net profit to Investment Trust Associates of $583,451.60.[682]

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shares were resold to International Securities Corporation of America without profit and in November were again resold to Investment Trust Associates for the account of the managers. In February 1928, Investment Trust Associates gave American Founders Corporation an option on the bank shares, and in March the shares were taken down by American Founders Corporation which currently disposed of them without profit or loss. (Id., at 22858–66.)

[678] Id., Commission's Exhibit No. X3520.

[679] The acquisition of Investment Trust Associates in October 1928 has been heretofore described in the development of the group. See supra, pp. 2137–2140.

[680] Op. cit. supra, note 1, Commission's Exhibit No. X3668.

[681] Id., Commission's Exhibit No. X3866.

[682] Ibid.

III. ACCOUNTING PRACTICES OF THE UNITED FOUNDERS CORPORATION GROUP OF INVESTMENT COMPANIES

A. Introduction and Summary

1. SUCCESS OF THE FOUNDERS SYSTEM IN RAISING CAPITAL—MISLEADING CLAIMS OF THE FOUNDERS COMPANIES

Depicted in the preceding section of this chapter[1] is the remarkable rise of the United Founders Corporation group of investment companies, its far-flung operations, its subsequent rapid decline and ultimate absorption by The Equity Corporation. In that section are described the methods by which this group, from an initial capital contribution of $500 in 1922,[2] developed into a pyramided system of investment companies and investment-holding companies with total paid-in capital of approximately $686,165,000 of which $503,627,000 was contributed by the public.[3] No other investment company or integrated group of investment companies in this country,[4] or apparently elsewhere,[5] has ever equaled this record in capital raising.

The success of the United Founders Corporation group in obtaining from the public more than one-half billion dollars in the form of capital contributions to the various companies of the group is largely attributable to the dynamic interaction of two factors: the highly auspicious period in which the Founders System was created and operated; and the special attributes which attached to the Founders companies in the mind of the investing public.

The essential characteristics of the period in question have been considered in another part of this report.[6] It will suffice to quote

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[1] See supra.

[2] Public Examination, American General Corporation, et al., at 20018, et seq.

[3] See supra, and Public Examination, American General Corporation, et al., Commission's Exhibit No. X3423–C. The difference of $182,338,000 between total paid-in capital and the public's contribution represents the paid-in value of securities of companies of the group held in the portfolios of other companies of the group. The immediate United Founders group of companies to which the figures stated above are applicable consisted of 13 companies, as follows: United Founders Corporation, American Founders Corporation, International Securities Corporation of America, Second International Securities Corporation. United States & British International Company, Ltd., American & General Securities Corporation, American and Continental Corporation, Investment Trust Associates, Founders Associates, Founders General Corporation, General Investment Corporation (formerly The Public Utility Holding Corporation of America), United States Electric Power Corporation, and United States & Overseas Corporation.

The last three companies named were formed by the United Founders Corporation group in association with other interests and have been separately treated in other parts of this study. (United States Electric Power Corporation is discussed in Pt. Four; General Investment Corporation and United States & Overseas Corporation are discussed in Ch. II of this part of the report, p. 497, et seq.) The remaining 10 companies had aggregate paid-in capital of approximately $470,080,000. For the securities of these companies the public had paid approximately $390,000,000, in addition to the amounts contributed by the various com-

briefly from the foregoing section in order to apprehend the fertile soil this period afforded for the germination and growth of the United Founders Corporation System:[7]

That the years 1921 to 1926 should have been the period of definite development of investment trusts and investment companies in this country was by no means wholly fortuitous. The economic and psychological conditions essential to the rapid propagation of this type of organization were concurrently present during this period. These conditions not only predisposed the investing public to participate in these relatively new enterprises but, as could have been expected, were exploited in the formation of investment companies and in the distribution of their securities, by numerous sponsors who were attracted by the profits from launching and operating the new industry.

The 1921 to 1926 period was one of great activity in finance and industry. Indexes show a steady increase in industrial activity, with only a slight setback in 1924. National income likewise grew at a rapid pace from approximately $58,000,000,000 in 1921 to over $79,000,000,000 in 1926, while corporate profits were at a high level. A long and steady increase in the price of common stocks accompanied this business improvement. Profits from investment in common stock appeared easy. This growing business prosperity and sustained rise in stock price encouraged and made popular investment policies predicated upon continuing growth in industry and common stock appreciation.

Launched at the start of this propitious period,[8] the United Founders Corporation System obtained an important lead over the hundreds of investment companies which followed[9] and reaped the advantages and prestige of a pioneer. Moreover, the Founders companies introduced, and widely publicized, features previously little known to the investment company in this country. Some of these innovations gained wide acceptance and currency, and the Founders group of investment companies continued to be associated in the public mind with them.

These repeatedly advertised qualities of the Founders companies are set forth and examined in a subsequent section of this chapter. Represented as having been borrowed from the British investment trusts, they included: restrictions on management discretion; broad portfolio diversification; complex capital structures resulting in substantial leverage; and elaborate research facilities.

The aforementioned publicized features doubtless contributed in some measure to the capital-raising success of the Founders companies. Of transcendent importance, however, were three complementary fac-

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panies of the group through the purchase of the securities of other companies of the group. The capitalization of the group is discussed in detail, supra.

[4] See statistics as to size of investment companies in this country set forth in Pt. Two of this report (House Doc. No. 70, 76th Cong.), Ch. II, Tables 13 and 38.

[5] In the Commission's supplemental report on Investment Trusts in Great Britain (House Doc. No. 380, 76th Cong.), the capital of the various British and Scottish groups is set forth on pp. 17 and 18. The largest there indicated is that of the Fleming group with total capital of £24.8 millions.

[6] Pt. One (House Doc. No. 707, 75th Cong.), Ch. III, p. 56, et seq.

[7] Ibid.

[8] International Securities Trust of America, the first of the Founders companies, was organized in 1921 and commenced to function in 1922.

[9] In the period 1921 to 1926, 139 investment companies came into existence (Pt. One, Ch. III, p. 64); between 1927 and 1930, 700 additional investment companies were created. (Pt. Two, Ch. II, pp. 29–32, Sec. III, A.)

tors: (a) the effective Founders' advertising campaign concerning the superlative knowledge and skill of the group's management in the realization of investment profits, (b) the impressive reported earnings continuously publicized by the Founders companies, and (c) the control which the Founders companies exercised over the market action of their securities.[10]

The persuasive effect upon the investing public of these three factors in combination is readily apparent. On the one hand were the alluring claims of the Founders companies to possession of an unerring formula for investment profits, implemented by unrivaled facilities for their realization. Juxtaposed, and in seeming validation of these claims were: (a) the continuous upsurge of the market price of the Founders securities, (b) numerous stock split-ups and dividends, and (c) the increasingly large earnings steadily reported by the Founders companies.

Under the compelling influence of these combined factors, the investing public, during the years 1922-1929, paid, as has been said, in excess of $503,000,000 for the securities of the 13 companies sponsored by the Founders group and approximately $390,000,000 for the securities of the 10 Founders companies proper which are the subject of the present report.[11] In 1935, when the surviving companies of the Founders group, after having come under the control of The Equity Corporation, were consolidated into American General Corporation, they had total net assets of about $50,000,000.[12] In these 10 companies, the indicated loss to the public, after due allowance for repurchases of stock and dividends paid, was approximately $245,000,000,[13]

[10] Thomas H. Benton, vice president of Founders General Corporation, the distributing medium of the Founders Group, affirmed the importance of these factors. He testified (Public Examination, American General Corporation, et al., at 24540–1):

> Q. You know that one of the things I believe you testified, that was very important to them [the Founders companies] was the advertising of this great skill in managing investments?
> A. Yes; there is no question about it.
> Q. And another feature you testified to was the fact that the great past earnings shown in the reports of your company, that that was a factor?
> A. The remarkable good record of the company was unquestionably a factor in the market.
> Q. And as you have already stated, supplementing those was the fact that you were in a position to buy to maintain a market or to sell if necessary to create it?
> A. Yes, sir.

[11] See note 3, supra.

[12] Public Examination, American General Corporation, et al., at 22201.

[13] This loss was computed as follows:

Total paid-in value of securities issued by the 10 Founders companies (as of November 30, 1929) (id., Commission's Exhibit No. X2434C)	$470, 080, 000	
Total of Founders companies securities held by other companies of the group	109, 060, 000	
Paid-in value of securities held by the public	361, 020, 000	
Excess over paid-in values paid by public at time of public distribution (see discussion, infra)	29, 439, 000	
Total amount originally paid by the public for the securities of the 10 companies of the group		$390, 459, 000
Deduct:		
Repurchases of securities from the public by companies of the group (id., Commission's Exhibit No. X3424b)	41, 571, 000	

(Footnote [13] continued on page 2223.)

or 63% of the amount originally invested [14] and 83% of the net investment.[15] The explanation for attrition of such severity, it is believed, may in large measure be found in the examination of those very factors which have been advanced as chiefly responsible for the Founders' success in gaining the confidence and the money of the investing public.

One of these factors—the control exercised by the United Founders Corporation group of companies over the market action of their securities—has been considered in the preceding section of this chapter; [16] in this section detailed consideration will be given to the remaining two factors. The reiterated claims of the Founders companies to possession of an unerring formula for the realization of investment profits based on international cyclical investment, will first be set forth. An analysis will then be made of the large investment profits, providing seeming authentication of these claims, reported by the Founders companies during the period 1928–1930, when the system was at its zenith. In this process the introverted and essentially fictitious nature of these profits will be revealed, and it will become clear that, contrary to the claim advanced by the United Founders

Dividends paid by companies of the group (id., Commission's Exhibit No. X3424G)	$15, 000, 000	
Premiums in excess of asset value paid on purchases for cash of securities of subsidiary Founders companies by top Founders companies (id., at p. 22211)	38, 000, 000	
Total returns to stockholders	94, 571, 000	
Net assets of Founders group at time The Equity Corporation acquired control	50, 000, 000	
Total deductions		$144, 571, 000
Total loss to investors		245, 888, 000

United States Electric Power Corporation, General Investment Corporation, and United States & Overseas Corporation, the three companies which have been excluded from the above computations, lost a total of approximately $204,000,000. Included in this loss, however, was the investment of the other 10 Founders companies in these three companies, totaling approximately $80,000,000. Some portion of this $80,000,000 accordingly represents a duplication of a portion of the $245,888,000 loss of the 10 companies, set forth above, but the precise amount of this duplication has not been ascertained. Even if it be assumed that the entire sum of $80,000,000 represents a duplication (which is definitely not the fact), the combined loss to the public from the $503,000,000 investment in the 13 companies affiliated with the Founders group would total approximately $370,688,000 ($245,888,000 plus $204,800,000 minus $80,000,000). This sum, which is less than the actual amount, nevertheless equals 34% of the total net loss to the investors of all management investment companies proper (including companies of the Atlas Corporation and The Equity Corporation groups) for the period 1927–1935. See Pt. Two (House Doc. No. 70, 76th Cong., Ch. VII, pp. 507–510), where it is stated that the net loss to the investors of the 242 management investment companies proper included in the study totaled $1,090,000,000 after allowing for dividends, interest and repurchases.

[14] This percentage results from the fraction $\frac{\$245{,}880{,}000}{\$390{,}459{,}000}$.

[15] This percentage is reached by deducting the amount returned to investors ($94,571,000) from the amount originally invested ($340,459,000) which gives a net investment for the entire period of $295,708,000. Since only $50,000,000 remained in 1935, the loss was $245,708,000, or $\frac{245{,}708{,}000}{295{,}708{,}000}$, which equals 83%.

[16] See supra, pp. 2108 et seq.

Corporation group these profits had no relation whatever to the Founders far-flung international investment activities, but were instead produced through unproclaimed but repeated use of a proficient technique of intercompany dealings within the framework of the Founders system.

Finally, the manner in which these and other vital facts were concealed from the stockholders and investing public through the use of accounting practices which, when they did not directly falsify, at least distorted, will be examined and discussed.

2. THEME OF THE FOUNDERS ADVERTISING: DOMINATION OF THE INTERNATIONAL BUSINESS CYCLE

The first of the investment companies which later comprised the United Founders Corporation Group was formed in 1921 and actually commenced operations in 1922.[17] At this period, American capital was embarking on its career of international finance which mounted rapidly during the following years until it attained a peak total of more than 14 billion dollars.[18] From the very outset, the management of the United Founders Corporation Group stressed to the investing public the element of international diversification, and emphasized that their companies were investors on a world-wide scale. Reflecting this emphasis, the first of the Founders companies was named "International Securities Trust of America"; the second was called "Second International Securities Corporation,"[19] and the third, "United States & British International Company, Ltd."

By 1926, prior to the formation of Second International Securities Corporation, the rationale of the investment policies of the Group had hardened into a formula which was stated and restated constantly in the advertising and the public announcements of the Founders companies. The formula in essence was as follows: Neither depressions nor inflations occur simultaneously in all coun-

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[17] Op. cit. supra, note 12, at 22011.

[18] See Pt. Two (House Doc. No. 70, 76th Cong.), Ch. VIII, pp. 602–3, Sec. IV, A, where it is stated "American foreign investments abroad, including both direct and portfolio investments, totaled over $14,000,000,000 in 1928 and 1929 and about $12,500,000,000 at the end of 1936."

The role of the United States in international finance during the post-war era has been discussed to some extent by the Commission in its Report on the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and Reorganization Committees, Pt. V. It was there said (p. 3 et seq.):

> Prior to the World War, American foreign investments were relatively small in amount, and, as a consequence, their effect on the country as a whole was not significant * * *.
>
> During the period of 1914–1919 the amount of foreign lending by American private interests was substantial in comparison with pre-war years. The year 1920, however, marked the beginning of a period during which American private capital, in the form of foreign loans, flowed abroad at an accelerating rate. The American bankers found a ready sale for foreign bonds in a market which for a time had no saturation point.
>
> It has been stated that the total amount of dollar issues, including those of foreign corporations as well as governmental entities, during the years 1920–1931 inclusive, reached the total of $9,363,519,600 (face or nominal amount).

The impetus to the formation of investment companies furnished by the public interest in foreign investments is discussed in Pt. One (House Doc. 707, 75th Cong.), Ch. III, p. 64 et seq.

[19] Weeks, Lewis & Bull Company, a Massachusetts Trust, which in 1925 was renamed "American Founders Trust," was earlier in point of time than Second International Securities Corporation, but it was intended originally as a "fiscal agent" for Internatioal Securities Trust of America, not as an investment company.

tries, and securities markets throughout the world are never all depressed or all buoyant at the same time. The Founders companies, trading internationally throughout the world, make their purchases in markets which are temporarily depressed and make their sales in markets which are buoyant. The companies are furnished with the information necessary to accomplish this result in a scientific manner through the resources of the elaborate and extensive research division maintained by American Founders Trust (subsequently American Founders Corporation).

Such, in substance, was the constantly reiterated theme of the Group's advertising and public announcements. In a special report to the shareholders of American Founders Trust, dated March 1, 1926, Louis H. Seagrave, president, stated the formula in the following words: [20]

There are few businesses more stable than investment trusts. Their assets, diversified in sound securities, are but slightly affected by special circumstances arising in particular industries or countries. Financial lethargy, economic disturbances, wars, strikes, and the ordinary disturbing factors of industrial stability do not exercise similarly adverse effects on investment trusts. On the contrary, the history of investments indicates rather clearly that such disturbances provide unusual investment opportunities. The business of organizing, supervising, and managing investment trusts, therefore partakes of their fundamental stability and soundness.

*   *   *   *   *   *   *

INVESTMENT TECHNIQUE

In its methods of purchase and liquidation, the Trust makes a distinct contribution to the theories and principles of investment trust administration, which it is believed may enable it and the trusts under its final supervision to surpass even the remarkable earnings of their British predecessors. Only securities of high grade are purchased, carefully selected under an eliminative process of effective statistical tests. Purchases are made only in depressed markets, chiefly on standing orders at fixed prices entered below the market. This system of buying necessitates continual analysis of many thousands of securities, and directs attention to depressed markets wherever they may occur throughout the world. Securities purchased are sold only when prices have advanced out-of-line with other eligible securities available in other markets. World markets are never all depressed or all buoyant at the same time, and conditions constantly change in all markets. The process of liquidation naturally occurs in buoyant markets. In such relatively rapid turnovers, the Trust realizes considerable profits, even though it keeps its investments always of a similarly high quality.

The Trust has thus created a new technique of investment trust administration, to supplement the diversification and watchfulness practiced by British investment trusts.

Three years later, in April 1929, a period when the Founders Group was receiving from the public for investment hundreds of millions of dollars of new capital,[21] with the stock market crash only

[20] Op. cit. supra, note 12, Commission's Exhibit No. X3463 (pp. 6–10).

[21] During the year 1929, the Founders Group raised approximately $366,000,000 in new capital for the various companies affiliated with the Group. (Id., at 22097 and Commission's Exhibit No. X3423–C.)

six months distant, Mr. Seagrave reiterated the familiar formula as follows:[22]

> This organization looks forward to the opportunities that should be presented through a price recession in this country just as it does in 30 other countries. * * * A substantial decline in securities prices will give us here, as it has often in other countries, the opportunity, long awaited, to buy securities at prices substantially below intrinsic values.
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> * * * * * * *
>
> A market relatively too high in one country or industry means nothing more than shifting investment attention to some market or field where prices or outlook are more favorable. There is never a time when securities in some important markets or industries are not distinctly "out of line" as compared with general prices in other markets or industries; and the broader the investment company's range of choice, the more will it be able to profit by variations from market to market at the same time, in selling where prices are comparatively buoyant and buying where they are comparatively low. * * *
>
> Investment companies in the American Founders Group are able to turn quickly, to the advantage of their shareholders, the divergent movements of security prices from country to country and from industry to industry. Commanding the investment service of American Founders Corporation, they are prepared to act at once when time is vital in meeting any investment opportunity. This capacity to operate internationally has been a principal factor in their success during recent years when a policy of caution has been followed in selecting American stocks for investment.

The simple formula which is threaded through the excerpts set forth above appeared constantly, and with but little variation, in most of the public pronouncements and advertising of the United Founders Corporation group from 1926 to 1930.[23]

It was a formula which was bound to commend itself to the popular mind by its ingenuous presentation of a purported economic verity, tinged with a measure of surface plausibility. It was, moreover, a formula which capitalized the contemporary vogue among American investors for international finance.[24]

By dint of constant repetition, the Founders' formula apparently served to create in the mind of the investing public an image of the Founders companies as great international investors, skillfully riding the waves of the international business cycle and scientifically garnering profits on the world's security markets, guided by the superlative research division of American Founders Corporation.

That the Founders companies were international investors is indisputable. Avoidance of American securities in favor of those of

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[22] Address of Louis H. Seagrave at the annual meeting of stockholders of American Founders Corporation, April 8, 1929, later printed and sent to stockholders. (Id., Commission's Exhibit No. X3840.)

[23] Additional quotations from the Founders' public pronouncements from 1926 to 1930, and reproductions of typical advertisements, are set forth in Appendix Q, infra, p. 2444.

[24] It is to be noted that, starting with the year 1925, foreign lending by United States investors reached new high levels. During the four-year period 1925–28 inclusive, new foreign loans in the United States exceeded $1,000,000,000 each year, a figure unequaled at any previous time in our history, except the year 1916. The year 1931 marked the end of this era of foreign lending. (Commission's Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees, Pt. V, p. 4.)

Europe and Asia comported with the judgment of the Founders management that, from 1926 on, the American securities markets were unfavorable for investment, "The whole market from practically 1926, 1927, 1928, and 1929 were all very fictitious markets in this country." [25]

In consequence, during the years 1926 to 1929, when prices on the American securities markets were advancing at an accelerating rate, purchases of American securities by the Founders management were sharply restricted. Instead, the investments of the Founders companies were being made in 30 different nations scattered over the face of the globe, including the Malay States, Siam, South America, India, Africa, Japan, and almost all the countries of Europe, with special emphasis on those of Central Europe, particularly Germany and Austria.[26]

The Founders management, in fact, took occasion to stress to their stockholders and the investing public their independence of the American securities markets and their ability to benefit from any recession on the American markets. For example, in a report to the stockholders of International Securities Trust, dated October 11, 1926, William R. Bull, chairman of the board of trustees, wrote: [27]

It may be of interest to you to know that but a small portion of the profits realized by your Trust in the process of reinvestment, since its organization nearly six years ago, has been realized upon American securities. At the time securities were depressed in the United States, the paid-in capital of your Trust was comparatively small. During the last two years, when capital was increasing at a very encouraging rate, high prices in the American markets have prompted your Trustees to seek investments in depressed foreign markets. Out of its entire earnings from appreciation, it is doubtful whether International Securities Trust has realized as much as 1/5 from appreciation on American securities purchased and sold. When a prolonged "bear" market is experienced in this country, your Trust will here enjoy its most lucrative buying opportunities.

In August 1929, in a publication of American Founders Corporation called "American Founders Bulletin," the following statement appeared: [28]

There has been considerable interest in the position of American investment trusts at the time of the recent break in the domestic market. American Founders Trust and the three general management investment trusts affiliated with it—International Securities Corporation of America, Second International Securities Corporation and United States & British International Securities Company, Ltd.—had as of June 1, total cash and call loans of approximately $19,000,000. * * * Total cash investments of the Group now exceed $120,000,000, exclusive of American Founders Trust's holdings of junior shares in the

[25] Statement of Erwin Rankin, manager of the Investment and Research Division of American Founders Corporation. (Op. cit. supra, note 12, at 24841.)

[26] As of November 30, 1928, the value (at cost) of the general portfolio of the Founders Group (excluding investments in affiliates and subsidiaries) equaled $99,318,320, of which $16,795,962 was invested in domestic securities as against $82,522,358 in foreign. Of the total investment in foreign securities, $29,995,978 was represented by German securities and $12,827,295 by those of Austria, Hungary and Poland, as compared with $5,983,306 in securities of the British Isles and $2,272,032 in those of France. (Id., at 22935–6 and Commission's Exhibit No. X3424E.)

[27] Id., Commission's Exhibit No. X3526.

affiliated companies. The four organizations named have also, under their regulations an aggregate short-term borrowing power exceeding $25,000,000.

Only 5 percent of the total cash and investments of the Group on June 1 was in domestic stocks. From June 1 to the date of writing (August 15) no substantial change has taken place in the American investments.

On April 8, 1929, Louis H. Seagrave, president of American Founders Corporation, addressing the stockholders of that company, stated:[29]

Substantially less than 10% of the combined assets of the Group, exclusive of our holdings of the securities of investment companies of the group, is now invested in American stocks.

In 1929 the Founders management began to throw off its earlier and proclaimed restraint with respect to American securities. During that year, large amounts of new money were rolling in upon the Founders companies by reason of the "proliferation of innumerable new companies" on the part of the Founders Group.[30] Large sums were placed by the Founders Group during 1929 in the American market, on what was described as "a short-term basis." Erwin Rankin, formerly manager of the Investment and Research Division of American Founders Corporation, testified in this connection:[31]

* * * Up to the end of 1928, we had almost no assets in the United States, had withdrawn them, thinking that the market had reached apparent reduceless elevation. In 1929, with the influx of capital that came into the group, we did go into the market on rather a short-term basis, on what you would technically call trading, put out a great deal of cash and money on call all through that period.

Mr. Rankin testified further in this connection as follows:[32]

Q. Is that your notion of the optimum function of any investment trust?

A. You mean trading?

Q. Yes.

A. No, I don't think it is a sound thing to do and you would only do it under very unusual conditions.

* * * * * * *

Q. Why raise capital to invest if that is the case?

A. Now you come to the main problem, it seems to me, that the investment corporation has. At the very time it is easier to raise capital, is the hardest time to invest. It is the same problem banks have in handling their own security portfolios.

Q. Who asks an investment trust to go out and raise capital under such circumstances? The bank at least may have people depositing with it, but what is the purpose of an investment trust going in and raising capital at a time like that if it can't use this capital soundly?

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[28] Id., Commission's Exhibit No. X4335.

[29] Id., Commission's Exhibit No. X3840.

[30] Testimony of Leland Rex Robinson, id., at 24987. Dr. Robinson also referred to "* * * this vast proliferation of related and associated companies, that grew really like a mushroom growth in 1929 * * *." (Id., at 24990.)

[31] Id., at 24841.

[32] Id., at 24869–71.

A. My answer to that is that is really the only time you can raise capital. Now if the investment trust is a sound proposition over a long period of years and you want to keep it going you have to get your capital during the time markets are high. It is the same thing with new financing all the time.

It thus resulted that the United Founders group of companies, despite the vaunted guidance of their elaborate research division, after having avoided investment in domestic securities at lower prices during the flourishing years 1926, 1927, and 1928, plunged heavily into American securities at the hyper-inflated prices prevailing in 1929, as the climax swiftly drew near. As of November 30, 1929, the percentage of American securities in the general portfolios of the companies of the group had, exclusive of investments in subsidiaries and affiliates, risen from the 10% reported by Mr. Seagrave at the beginning of the year to approximately 42%.[33] In terms of dollars, holdings of domestic securities had risen from $16,795,962, at cost, as of November 30, 1928, to $129,097,505 as of November 30, 1929.[34] At the same time, investments in subsidiary and affiliated companies increased from $35,216,281 as of November 30, 1928, to $425,714,603 as of November 30, 1929.[35]

Nevertheless, despite this abandonment of policy in 1929, to the extent that the image wrought by the earlier Founders' advertising depicted the group as great international investors, it possessed a measure of similitude; this resemblance, however, penetrated no further than the surface. For it was not from these publicized activities that the Founders companies derived the bulk of their profits. During the three-year period 1928–1930, the combined net profits on investments realized by the group totaled $43,289,733.[36] In the light of these earnings it was necessarily inferable that the companies of the group were not only international investors, but successful international investors; that they not only bought and sold in the world's security markets, but that they amassed large profits in the process.

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[33] These percentages relate only to general portfolio and exclude cash on hand and holdings of securities of subsidiary and affiliated companies. (Id., Commission's Exhibit No. X3404–E2.) Purchases of American securities were intensified after the market break in 1929 and continued during the early part of 1930. Early in 1930 United Founders Corporation borrowed from banks more than $20,000,000 for the purpose of further market purchases. (Id., at 24911.) By the end of 1934 domestic securities in the general portfolio exceeded 95% of the total. The percentage of general portfolio holdings in American securities at reporting dates was as follows (id., Commission's Exhibit Nos. X3404–E2 to E12, inclusive):

November 30, 1929	42.373	May 31, 1933	81.371
May 31, 1930	51.634	November 30, 1933	93.682
November 30, 1930	53.334	May 31, 1934	96.670
May 31, 1931	58.256	November 30, 1934	95.782
November 30, 1931	57.066	May 31, 1935	89.114
May 31, 1932	57.826	August 31, 1935 (United Founders)	90.821
November 30, 1932	80.058		

[34] Id., Commission's Exhibit Nos. X3424B and X3424E.

[35] Although never revealed to the stockholders, holdings in subsidiary and affiliated companies greatly exceeded geenral portfolio investments. For example, as of November 30, 1929, total investments of the Founders Group equaled about $678,000,000 (cost), of which $425,714,603 represented investments in subsidiary and affiliated companies and $252,390,755 in general portfolio. Of the general portfolio, $129,097,505 was invested in American and $123,293,230 in foreign securities, approximately $52,000,000 being invested in German securities alone. (Id., at 22938–9 and Commission's Exhibit No. X3424B.)

[36] Id., Commission's Exhibit No. X3732.

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3. FALSITY OF THE PICTURE PROJECTED BY THE FOUNDERS MANAGEMENT

In this important respect the picture was a distortion, for, as will be shown, the profits which the Founders companies reported had almost no relation to their international investing. Instead, these profits resulted entirely from extraordinary and varied transactions in the securities issued by the companies of the group and their affiliates. Actually, the entire sum of $43,289,733 which, it has been stated, comprised the totality of investment profits of the Founders Group and affiliates for the three-year period 1928–1930, inclusive, was derived exclusively from transactions of this character (hereafter generally referred to as "intercompany transactions").[37] In fact, these intercompany transactions showed a profit of $46,683,319 for the period,[38] but approximately $3,300,000 of this sum was required to offset a loss of that amount in general portfolio transactions, thus reducing the total net profit to $43,289,733. For the entire period, therefore, profits derived by the group from purchases and sales of securities of the group equaled 108% of all investment profits of every description.

When the figures for the three-year period are broken down on an annual basis, it is apparent that, even prior to the collapse in the securities markets, profits from intercompany transactions constituted an important part of all reported profits. For example, for the year 1928 the profits realized by International Securities Corporation of America, Second International Securities Corporation, and United States & British International Co., Ltd., from transactions in securities of companies within the Founders Group, equaled 43% of all investment profits reported that year by this group of companies.[39] For the same year the profits realized by American Founders Corporation from transactions in securities of companies within the group equaled 77% of all investment profits shown by it for that year.[40] In 1929 the percentage of intercompany profits to all profits was even greater: 95% of all investment profits reported by American Founders Corporation as realized profits for itself and five of its subsidiary companies during the fiscal year 1929 were derived directly and wholly from dealings in securities of companies of the Founders Group and affiliates.[41]

From the detailed account of the intercompany transactions which constitutes subsection B of this section, the introverted and deceptive

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[37] The expression "intercompany transactions" is not always used in this report in its narrow technical sense as connoting transactions wholly confined to two or more affiliates. Frequently it is used broadly to characterize transactions between affiliated Founders companies involving securities of Founders companies, in which one or more of the affiliates realized a profit, even though a sale outside the Group may have been made in the final stages of the transaction.

[38] It should be noted that this sum of $46,683,319 is exclusive of $5,619,384 realized by United Founders Corporation in connection with the receipt and disposition of rights for the purchase of United States Electric Power Corporation common stock, discussed in detail, Sec. B, 4, b, infra. If this sum is added, as it should be in measuring the group's performance during this period, the total of profits resulting from intercompany transactions is seen to have totaled $52,302,703.

[39] Op. cit. supra, note 12, Commission's Exhibit No. X3732. Total investment profits, $4,115,813; intercompany profits, $1,787,526.

[40] Ibid. Total profits, $2,937,943; intercompany profits, $2,249,504.

[41] Ibid. Total investment profits, $17,609,000; intercompany profits, $16,684,000.

character of the vast "profits" generated by these transactions will clearly emerge. It will be seen that although they were actually "realized," these "profits" were artificial and fictitious, deriving their existence solely from the unique relationship of the Founders companies, through whose thin and porous corporate walls they surged back and forth in tidal fashion, at the command of those who comprised the inner management group. Moreover, large amounts of these so-called profits were not profits at all, but were essentially reallocations by certain Founders companies of portions of their contributed capital to other companies of the group.

Each company at different times was the source of such "profits" to the others, and itself was in turn the recipient of similar profits from others. The basic pattern was simple: Founders Company A would bring out an issue of 90,000 shares of no-par common stock. Founders Companies B, C, and D would each purchase 30,000 shares from A, paying it $10 a share. Founders Companies B, C, and D would, after a period varying from several days to several months, resell the stock to the public at $20 a share through the medium of Founders General Corporation, the distributing agency of the group. Result: the public would have paid $1,800,000 for the 90,000 shares of stock; Company A would have received $900,000 of capital; Companies B, C, and D would have recorded $900,000 in "profits."

These "profits," which frequently exceeded 100% on cost,[42] were euphemistically termed by former officers of the Founders System "underwriting profits,"[43] but were reported tersely to stockholders in the companies' financial reports as "profits on investments." Thus, the purchasers of the stock of Company A were unaware that only a portion of the capital contributed by them had reached their company; and the stockholders of Companies B, C, and D were unaware that a substantial part of the "earnings" reported by their companies represented diverted capital of affiliated companies.[44]

This, as has been said, was the basic pattern, and in simplest form; variations and embellishments were many. When this pattern is traced and retraced through the numerous transactions recounted in the body of this report, it will become clear that the Founders companies, instead of amassing their profits by trading on the securities markets of the world, were engaged in a parasitical process of fattening upon one another. Each company's "investment profit" was

[42] See, for example, details of "profits" recorded by Investment Trust Associates on stock of United Founders Corporation equaling 135%, 163%, and 525% on cost (infra, pp 2250 et seq.) ; profits of 400% realized by American & General Securities Corporation on stock of Investment Trust Associates (ibid.) ; profits of 95% to 165% realized by Founders General Corporation on stock of United Founders Corporation (ibid.) ; and many others.

[43] See testimony and statements of Leland Rex Robinson (op. cit. supra, note 12, at 24961), Royal E. T. Riggs (id., at 24852), Rufus Tucker (id., at 24932), and Erwin Rankin (id., at 24900). Dr. Robinson expressed himself as now being in favor of completely prohibiting investment companies from realizing underwriting profits in connection with the distribution of the securities of an associated or affiliated company. "I say that despite the fact we made a huge profit in 1929 as a result of it." See note 101, infra.

As compared with the so-called "underwriting profits" of 100% to 500% recorded by the Founders companies, the average gross spread or underwriting fee paid by investment companies during the period 1927–1935, as determined from a study of $2,109,000,000 of securities issued, was 5.8%. (Part Two [House Doc. No. 70, 76th Cong.], Ch. III, pp. 203–6 and Table 67.)

[44] See infra, pp. 2250 et seq.

siphoned out of another company's contributed capital. Such a process obviously could not long continue in the case of a static system. But in the instance of the United Founders Corporation group, an accelerating flow of new companies constantly brought fresh vitality and a new lease on life in the form of additional stock issues. As the public poured in the capital for these new companies by the purchase of their securities, a portion of this capital could at once be drained off by the older companies of the group, and transformed into additional "profits" through the simple species of bookkeeping legerdemain which has been outlined. These "profits" reported in turn by the Founders companies to their stockholders, in financial reports which stressed the merits of the Founders international investment technique, served to assure the investing public anew, and thus to induce further contributions of capital to the reporting companies and to still other companies to be sponsored by the Founders Group.

The process was not interminable, however. The time came when the public's faith in stocks and in the stock market abated, and the stream of capital contributions ceased. Forthwith, the endless chain of Founders' "profits" was severed, and the supervening collapse of the Founders system was inevitable.

4. THE UNITED FOUNDERS CORPORATION SYSTEM AT ITS ZENITH: THE YEARS 1928–1930

Although most of the practices discussed in this report had their origin in the formative years of the Founders System, they attained their full development concurrently with the development of the Founders structure itself, and may, therefore, best be studied in the mature organism. Accordingly, the evolution of the United Founders Corporation Group in the period covered will now be summarized briefly, in order to sketch a background against which the accounting practices which are the principal subject of this section may be projected.

At the start of the year 1928, the Founders Group consisted of only three investment companies: International Securities Corporation of America, Second International Securities Corporation, and American Founders Trust (later transformed into a corporation, and hereinafter referred to as American Founders Corporation).[45] These three organizations were interrelated through the following circumstances:

(a) American Founders Corporation served as fiscal agent for the other two investment companies, in which capacity it distributed to the public the securities of these companies and raised for them their entire capital;[46]

(b) International Securities Corporation of America and Second International Securities Corporation were under contract with American Founders Corporation to receive from American Founders Corporation complete investment services;[47]

(c) American Founders Corporation owned more than 80% of the Class B stock of International Securities Corporation of America and 100% of the Class B

[45] Op. cit. supra, note 12, at 22076. American Founders Corporation also owned an office building, title to which was held by a subsidiary, American Founders Office Building Co., Inc. (Ibid.)

[46] For a discussion of the role played by American Founders Corporation as fiscal agent for the other companies of the group, see supra, p. 2222.

[47] Op. cit. supra, note 12, Commission's Exhibits Nos. X3426 and X3406.

stock of Second International Securities Corporation[48] by virtue of which ownership it possessed effective working control of these corporations;[49] and

(d) the principal officers of International Securities Corporation of America and Second International Securities Corporation were simultaneously officers or directors of American Founders Corporation.[50]

At the start of 1928 the three companies had raised in capital an aggregate of approximately $78,000,000 as follows: American Founders Corporation, $16,789,000; International Securities Corporation of America, $45,580,000; and Second International Securities Corporation, $15,500,000.[51]

Starting the year 1928 with the pattern sketched above, the Founders Group in the course of the year 1928 effected the largest expansion of any previous year in its history. This expansion had a double aspect. First, each of the companies within the group expanded through raising additional capital from the sale of stock, or in the case of International Securities Corporation of America, through the sale of bonds. Second, the number of companies within the group was greatly increased as the result of the addition of four new companies organized by the group during that year.

The first new company sponsored in 1928 by the Founders Group was United States & British International Company, Ltd., organized in January by Founders, in conjunction with several investment banking firms and the British banking house of Helbert, Wagg & Co., Limited, of London. United States & British International Company, Ltd., in turn formed a subsidiary called Trans-Oceanic Trust, Ltd., which was a British investment trust organized in England and managed by Helbert, Wagg & Co.[52]

In February 1928, American Founders Corporation organized Founders General Corporation, a wholly owned subsidiary, which took over from American Founders Corporation the function of distributing the securities of the Founders Group of companies, assertedly because it was felt that American Founders Corporation was no longer suited for this activity because of its changed character.[53]

In October 1928, the Founders Group formed America & General Securities Corporation as a management investment company, partly in order to escape the restrictions imposed on management discretion in the charters or declarations of trust of the earlier Founders companies.[54]

In November 1928, the Founders Group took over from Christopher F. Coombs the charter and the name of a company which until that time, had been a personal holding company for Mr. Coombs. This company was named Investment Trust Associates and thereupon

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[48] Id., Commission's Exhibit No. X3466A.

[49] Id., Commission's Exhibit Nos. X3426 and X3406.

[50] Id., Commission's Exhibits Nos. X3466A, X3401, and X3406.

[51] Id., at 22074. Of this capital $3,800,000 was represented by securities of International Securities Corporation of America held within the group, and $2,976,000 of securities of Second International Securities Corporation held within the group, these being Class B shares of the two companies.

[52] Id., at 22078–80.

[53] Id., at 22087.

[54] Id., at 22081.

was transformed into an investment company of the management type, affiliated with the Founders Group.[55]

While these new companies were being launched during 1928, the older companies were, as has been indicated, expanding through the sale of additional securities. American Founders Corporation, at the end of 1928, had increased its capital to $27,897,000; International Securities Corporation of America, to $66,000,000; Second International Corporation, to $22,500,000. In addition, the newly organized United States & British International Company, Ltd., had received more than $16,000,000 during 1928, and American & General Securities Corporation had received a like sum; Investment Trust Associates received $3,400,000, and Founders General Corporation, $1,075,000. The total capital recorded by the companies of the Founders Group at the end of 1928 aggregated $153,000,000, an increase of approximately $75,000,000 from the total at the end of 1927.[56]

Successful as had been the year 1928 for the group with respect to increase in number of companies and capital, it was surpassed in both respects by the year 1929.[57]

In January 1929, the Founders Group participated with Harris, Forbes & Co. and the Deutsche Bank of Berlin in the formation of United States & Overseas Corporation, the purpose of which was to furnish intermediate credits to Continental European borrowers and to engage in investing generally. The interest of the group in this new affiliate was increased in May 1929, and American Founders Corporation participated in the management of the company.[58]

In February 1929, the Founders Group undertook a one-third participation in the formation of the North and South American Corporation, together with Baker, Kellogg & Co., Inc., and A. G. Becker & Co., Inc., the primary purpose of which was to invest in South American securities, mainly in the Republic of Colombia.[59]

In April 1929, the group participated with four investment bankers in the formation of Seaboard Investment Trust, whose principal assets were securities of the Washington Gas Light Company and its subsidiaries.[60]

In May 1929, the group participated jointly with Tri-Continental Corporation and with the European banking house of Ephrussi & Co. of Vienna in the formation of International and General Corporation, the primary purpose of which was to make investments in South Europe, particularly in Austria.[61]

In May 1929, the Founders Group purchased working control of American and Continental Corporation which had been organized

[55] Id., at 22096.

[56] Id., at 22097. Intercompany holdings amounted to $15,550,000, leaving an indicated contribution by the general public of $137,500,000.

[57] It will be recalled that it was respecting this year that Leland Rex Robinson spoke of "* * * this vast proliferation of related and associated companies that grew like a mushroom growth in 1929." (Id., at 24990.)

[58] Id., at 22100 et seq. Louis H. Seagrave testified that "intermediate credits usually ran from one year to five years. They were usually too long for the commercial banks and the amounts were frequently too small for public flotation." (Id., at 22116.)

[59] Id., at 22110.

[60] Id., at 22108.

[61] Id., at 22109.

five years earlier by Kuhn, Loeb & Co., International Acceptance, Inc., Dillon, Read & Co., and The North American Company, for the purpose of investing in foreign securities, especially German securities, and to lend money in the form of intermediate credits.[62]

In September 1929, the Founders Group, together with Harris, Forbes & Co., formed The Public Utility Holding Corporation of America (later renamed General Investment Corporation), which held controlling interests in utility and railroad properties in the United States and foreign countries.[63]

In September, the Founders Group also organized United States Electric Power Corporation in conjunction with a number of other interests, chief among which were those of the Belgian financier, Alfred Loewenstein, and an American banker, Victor Emanuel. United States Electric Power Corporation acquired important holdings in American and foreign public utilities, including joint control with H. M. Byllesby and Co. of the billion-dollar Standard Gas and Electric Company utility system.[64]

During 1929, not only was the Founders Group greatly expanded, but effective steps were taken to consolidate in the hands of the individuals who comprised the management group, control of the system which theretofore had been somewhat diffuse, and which they feared might be wrested from them.[65]

In February 1929, Louis H. Seagrave, Christopher F. Coombs, and Frank B. Erwin, the three persons who together constituted the inner management group of the Founders System, organized United Founders Corporation as a holding company for the common stock of American Founders Corporation. Effective and permanent control of the new corporation was lodged in these three individuals by the device of issuing to them all the Class A common stock of the corporation, which had voting power equal to one-half of the voting power of the total outstanding common stock, irrespective of the total amount of common which might be issued, and equal to one-third of the voting power of all classes of stock combined.[66] In return for this stock, Messrs. Seagrave, Coombs, and Erwin transferred to the corporation 12,500 shares of American Founders Corporation common stock having a quoted market value at the time of approximately $1,000,000. The contribution of the investing public to the capital of United Founders Corporation eventually totaled $297,000,000.[67]

In October 1929, American Founders Corporation offered to exchange its common stock for the Class A common stock and preferred stocks of its four affiliated companies: International Securities Corporation of America, Second International Securities Corporation, United States & British International Co., Ltd., and American

[62] Id., at 22114–5.

[63] Id., at 22118.

[64] Id., at 22190.

[65] Id., at 22181.

[66] To insure the permanence of this control, an agreement was entered into between the three organizers immediately after the issuance of the stock which provided that it would be voted as a unit and that each of the three parties to the contract had a first refusal on the sale of the others' holdings. (Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees, Pt. VII, p. 213.)

[67] Ibid.

& General Securities Corporation. By the end of 1929, American Founders Corporation had acquired 80% of the outstanding securities of these four companies.[68] Thus, with United Founders Corporation in control of American Founders Corporation and American Founders Corporation in control of the four principal Founders companies, and with all six in turn holding substantial blocks of stock of the various other affiliated companies, the Founders Group, at the end of 1929, presented the familiar pattern of a pyramided holding company system. Control of this system, which at one time dominated resources in excess of $2,000,000,000,[69] rested in the hands of the three individuals who controlled the top holding company, United Founders Corporation.

As of November 30, 1929, the capital of the 10 companies which actually formed the Founders Group proper totaled $470,000,000, of which $109,060,000 was represented by intercompany holdings.[70] The capital of the group plus its three principal affiliates[71] exceeded $686,000,000, with intercompany holdings of $182,338,000.[72]

During the year 1930 little change occurred in the outward form of the Founders System; however, United Founders Corporation acquired majority control of United States Electric Power Corporation by buying out its associates in the sponsorship, and The Public Utility Holding Corporation (General Investment Corporation) acquired some nine subsidiaries and affiliates.[73]

The background of the United Founders Corporation System during the period 1928–1930 having been sketched above, consideration will now be given to the accounting practices which are the principal subject of this section.

5. ACCOUNTING PRACTICES AND THE ROLE OF THE INDEPENDENT ACCOUNTANTS

The present section of this report is concerned not alone with exposing the true character of the profits reported by the companies of the United Founders Corporation group, but seeks also an explanation for the continued ignorance of the stockholders and the investing public of the actual facts. No attempt is made in this section to deal with the activities of the companies which occasioned a loss to the investing public of several hundred million dollars (a subject which is treated in the preceding section of this chapter), but rather with the manner and methods by which the public was misled as to the nature of the companies in which it was induced to invest some five hundred million dollars. In this far-reaching deception of the investing public, the role played by the independent public accountants was of cardinal importance.

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[68] Op. cit. supra, note 12, Commission's Exhibit No. X3405.

[69] A detailed itemization of this figure is set forth, supra, pp. 2108 et seq.

[70] Op. cit. supra, note 12, Commission's Exhibit No. X3424C. For the names of the companies, see note 3, supra.

[71] The Public Utility Holding Corporation of America, United States Electric Power Corporation, and United States & Overseas Corporation.

[72] Op. cit. supra, note 12, Commission's Exhibit No. X3423C. These 13 companies had 9 other companies affiliated with them, making a total of 22 companies affiliated with the United Founders Corporation group. The complete list is set forth, supra, pp. 2108 et seq.

[73] See Chart 12, p. 2114, supra, for a portrayal of the interrelationships of the companies within the Founders System.

The stockholders of the Founders companies were, of course, supplied with periodic financial reports concerning the operations of their companies, and it was to these reports that stockholders were, for the most part, limited for information on this subject. Nevertheless, these reports contained no indication of the true character of the profits impressively set forth in their pages. There was not a word in these reports to suggest even to the informed reader that a large portion of the profits set before the stockholders must be disassociated from the prefatory statements concerning the Founders Group's successful international investment technique. A reading of only the carefully phrased statements of the management prefacing the reports would, of course, merely confirm the picture painted by the Founders management as outlined in the excerpts previously quoted. A further and careful study of the balance sheets and income statements, however, effected no change in the picture, for these financial statements served ostensibly but to reaffirm the statements of the management.

Moreover, to dispel any doubt and instill entire confidence, the financial reports bore the name, not of one, but of two prominent firms of independent public auditors and accountants, one of which was designated as "auditors," and the other as "consulting accountants."[74] The standing of these firms was such as to place a stamp

[74] The "auditors" subscribed the balance sheet, income statements and exhibits, and furnished the certificate. The function of the "consulting accountants" is considered infra, p. 2404. Set forth below is a table giving the names of the accounting firms which served the Founders companies in one or the other capacity during the period covered.

AUDITORS

	United Founders Corporation	American Founders Corporation	International Securities Corporation of America	Second International Securities Corporation	United States and British International Co., Ltd.
1924		CO&C	PW&Co.		
1925		CO&C	PW&Co.		
1926		CO&C	LS&F		
1927		CO&C	LS&F	LS&F	
1928		CO&G	LS&F	LS&F	LS&F
1929	CO&G	CO&G	LS&F	LS&F	LS&F
1930	LS&F	LS&F	LS&F	LS&F	LS&F
1931	LS&F	LS&F	LS&F	LS&F	LS&F
1932	LS&F	LS&F	LS&F	LS&F	LS&F
1933	LS&F	LS&F	LS&F	LS&F	LS&F
1934	LS&F	LS&F	LS&F	LS&F	LS&F
1935	LS&F	LS&F	LS&F	LS&F	LS&F

AUDITORS

	American and General Securities Corporation	Investment Trust Association	American and Continental Corporation	United States Electric Power Corporation	Public Utility Holding Corporation
1924					
1925					
1926					
1927					
1928	LS&F				
1929	LS&F	LS&F	H&S		
1930	LS&F	LS&F	H&S	H&S	H&S
1931	LS&F	LS&F	H&S	H&S	H&S
1932	LS&F		H&S	H&S	H&S
1933	LS&F		H&S	H&S	H&S
1934	LS&F		LS&F		H&S
1935	LS&F		LS&F		

(Footnote 74 continued on p. 2238.)

of indubitable authenticity on the reports which bore their names, a factor which the Founders management, in their reports to the stockholders and in their advertising literature, did not fail to exploit by stressing this double "protection" accorded the Founders' stockholders.[75]

CONSULTING ACCOUNTANTS

	United Founders Corporation	American Founders Corporation	International Securities Corporation of America	Second International Securities Corporation	United States and British International Co., Ltd.
1924					
1925					
1926					
1927			H&S	H&S	
1928		LS&F	H&S	H&S	H&S
1929	LS&F	LS&F	H&S	H&S	H&S
1930	H&S	H&S	H&S	H&S	H&S
1931	H&S	H&S	H&S	H&S	H&S
1932	H&S	H&S	H&S	H&S	H&S
1933	H&S	H&S			
1934					
1935					

CONSULTING ACCOUNTANTS

	American and General Securities Corporation	Investment Trust Association	American and Continental Corporation	United States Electric Power Corporation	Public Utility Holding Corporation
1924					
1925					
1926					
1927					
1928	H&S				
1929	H&S				
1930	H&S	H&S			
1931	H&S	H&S			
1932	H&S				
1933	H&S				
1934					
1935					

Key to names:

CO&C = Clarke, Oakes & Clarke.
CO&G = Clarke, Oakes & Greenwood.
H&S = Haskins & Sells.
LS&F = Loomis, Suffern & Fernald.
PW&Co. = Price, Waterhouse & Co.

Auditors and consulting accountants for companies of the United Founders Corporation group. (See note 72, supra and testimony respecting the function of the consulting accountants, Sec. D, infra.)

[75] For example, American Founders Bulletin No. 1, August 1928 (op. cit. supra, note 12, Commission's Exhibit No. X4335), under the caption, "Protecting the Investor," stated (pp. 10–11):

> The audits and reports are made for each company by two firms of certified public accountants. One firm, designated as the auditors of the Company, prepares the annual balance sheet and income statement which is incorporated in the annual reports to stockholders. When the Board so requires, they may also make semi-annual income audits. The other firm of accountants, designated as the Company's consulting accountants, maintain a representative in the office of the company, who has immediate access to the financial records, and reports thereon to the directors. Each company has appointed Messrs. Loomis, Suffern & Fernald as auditors and Messrs. Haskins & Sells as consulting accountants for the year 1928.

The annual report of American Founders Corporation for 1929 (id., Commission's Exhibit No. 3404–E2) listed on the flyleaf, under the heading "Auditors," "Messrs. Clarke, Oakes & Greenwood, Accountants and Auditors" and "Messrs. Loomis, Suffern, & Fernald, Certified Public Accountants." The consolidated balance sheet and income statements were subscribed by both firms, and the certificate was made jointly. In the text of the report (p. 11) it was stated "Messrs. Loomis, Suffern and Fernald are auditors for the four

(Footnote [75] continued on p. 2239.)

The nature of the relationship between public accountants and the stockholders of the company whose accounts are stated and certified, and the extent of the duty owed by accountants to the latter, are developing concepts in the law and in practice.[76] No attempt will be made, consequently, in this report to formulate these concepts. It can be stated without reservation, however, that if, as the Founders' advertising suggested, protection was something which the stockholders of the Founders companies had a right to expect from the eminent firms of accountants whose names graced the companies' reports, this protection they failed to receive in numerous and important respects. The conclusion seems unavoidable, furthermore, that these public accountants, by their condonation and adoption of unwholesome management accounting practices, as well as by their own disregard of sound accounting principles in the preparation and certification of published financial statements, actively aided in the deception of the Founders stockholders and the investing public.

No intimation is made that the accountants for the Founders companies promulgated either figures or information which were themselves intrinsically false. But deception resulted nonetheless from the repeated failure to disclose in the financial statements important and material information which, if disclosed, would have cast new and entirely different light on that information which was furnished. This is merely to repeat the familiar truism, now embodied in law,[77] that frequently partial disclosure is tantamount to falsification.

While evaluation and criticism of accounting practices have been handicapped in the past by the asserted nonexistence of a recognized body of accounting principles to serve as an effective criterion, this problem has been the subject of extensive study in recent years by accountants, both practicing and academic; as a result this difficulty

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subsidiary investment companies and Messrs. Haskins & Sells are consulting accountants for the companies." Other examples of statements in which "protection of the investor" is stressed are set forth in section C, infra.

[76] See, for example, the recent case of *State Street Trust Company* v. *Ernst,* 278 N. Y. 104, 15 N. E. (2nd) 416, where public accountants were held liable to creditors for gross negligence, despite the absence of any contractual relationship. Cf. *Ultramares Corporation* v. *Touche,* 255 N. Y. 170, 174 N. E. 441 (1931), *O'Connor* v. *Ludlum,* 92 F. (2d) 50 (1937), Cert. den., 302 U. S. 758; *Landell* v. *Lybrand,* 264 Pa. 406, 107 Atl. 783 (1919). As was stated by one commentator with respect to the *State Street Trust* case:

> There would then seem to be evolving from that area of fraud in which liability may be imposed in the absence of specific state of mind a standard of care differing from negligence in degree, rather than any presence of moral culpability. (Decisions Note (1939) 39 Columbia Law Rev. 688, 692.)
>
> See also: Rich, *Legal Responsibilities and Rights of Public Accountants* (1935), Ch. I, Sec. VI; *Annotation,* Liability of Public Accountant, 120 A. L. R. 1262; MacMillan, Sources and Extent of Liability of a Public Accountant (1937), 63 Journal of Accountancy 417.

For the civil liability of accountants to investors under the Securities Act of 1933 and the Securities Exchange Act of 1934, see Section 11 of the former and Section 15 of the latter; for the criminal liability, see Sections 24 and 32, respectively; and Rich, op. cit. supra, Ch. I, Secs. V and VII.

See also an article by F. S. Fisher, Jr., "The Integration of Legal and Accounting Concepts." in *Papers on Accounting Principles and Procedure* (1938), published by the American Institute of Accountants, where it is stated (p. 51):

> Prior to 1930, or thereabouts, it was, commonly, if not correctly, accepted, that the major services performed by the financial statement were, in the first instance to acquaint the management with the status of the business, and secondly, to afford to present and prospective creditors a basis upon which to determine what their credit policies would be. By 1933, however, there came to the fore a third purpose. With the enactment of the Securities Act of 1933, the interest of existing and prospective investors was materially emphasized.

[77] Securities Act of 1933.

is, in the judgment of leading members of the profession, being rapidly reduced at the present time.[78]

Without seeking at this time to postulate standards for the accounting profession, it may nevertheless be said that the signature of the public accountant in conjunction with an affirmative certificate, no matter how narrowly worded, affixed to a financial statement necessarily import something more than the accountant's belief in the mathematical correctness of the figures therein set forth. It must be a fundamental assumption that the reader of the statement is entitled to conclude, at the least, from the very presence of the accountant's signature on a report which purports to express general agreement with the statements, not only that the figures set forth are correct, but that they are set forth in a manner calculated to disclose the truth, rather than to obscure it; not only that these figures have been arrayed and evaluated by the accountant in accordance with sound and recognized principles of accounting, but that they have been arrived at on the basis of sound and consistent accounting practices on the part of the company;[79] not only that all information disclosed is correct, but that all important information is disclosed which is necessary to make the statements not misleading. In the case of the Founders companies, each of these fundamental assumptions was repeatedly violated.

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[78] In *A Statement of Accounting Principles* recently formulated jointly by three authorities (Thomas Henry Sanders, Harvard University Graduate School of Business Administration; Henry Rand Hatfield, University of California; Underhill Moore, Yale University School of Law), 1938, and published by the American Institute of Accountants, it is stated (pp. 5, 6) :

> There is, it is believed, a corpus of principles of accounting which are generally accepted. It is true that they are not "written law": they have not been codified; they must be sought in accounts and financial statements in treaties and in other evidences of professional opinion. It is true that they have not been adopted by vote of the profession. But that they have been accepted is evidenced by the common ways of thought and speech which make communication in accounting matters possible by the general uniform practices of all accountants when dealing with some situations, by the general agreement that, among all the possible ways of dealing with other situations only a few can be used with propriety, by the restrictions of controversy in respect of propriety to a relatively small number of situations out of the innumerable number about which disagreement is possible. So fully is the existence of a body of accepted accounting principles recognized that accountants commonly state in their reports and certificates that the statements presented have been prepared "in accordance with accepted principles of accounting."
>
> The existence of a body of generally accepted accounting principles does not mean that there is only one proper accounting treatment for every situation with which the accountant must deal. For many such situations there are available a number of treatments which are in accord with generally accepted principles. But the affirmation of the general acceptance of accounting principles does mean that many and indeed, most of the possible treatments are inappropriate. The failure to see that it is not the essential nature of a principle to forbid all courses of action save one, that a rule of conduct which permits some courses of action and forbids others is a principle, explains, it is believed, the denial by some of the existence of accounting principles and their general acceptance.

This Commission has also sought to aid in the crystallization of a recognized body of accounting principles by the issuance of its Accounting Series releases reviewing such principles generally and in their application to specific problems. Accounting Series Release No. 4 expresses the policy of the Commission concerning accounting principles as follows:

> In cases where financial statements filed with this Commission pursuant to its rules and regulations under the Securities Act of 1933 or the Securities Exchange Act of 1934 are prepared in accordance with accounting principles for which there is no substantial authoritative support, such financial statements will be presumed to be misleading or inaccurate despite disclosures contained in the certificate of the accountant or in footnotes to the statements provided the matters involved are material. In cases where there is a difference of opinion between the Commission and the registrant as to the proper principles of accounting to be followed, disclosure will be accepted in lieu of correction of the financial statements themselves only if the points involved are such that there is substantial authoritative support for the practices followed by the registrant and the position of the Commission has not previously been expressed in rules, regulations or other official releases of the Commission, including the published opinions of its Chief Accountant.

[79] It is significant that the form of accountant's certificate recommended by a special committee of the American Institute of Accountants (given in a bulletin entitled "Examination of Financial Statements by Independent Public Accountants" [1936]) and now widely em-

An account of the important information withheld from the stockholders of the Founders companies and not revealed by the accountants in the financial statements approved by them, would be long and necessarily enmeshed with detail. In order merely to indicate the sweep of the vital subjects concerning which stockholders and the investing public were kept in ignorance, and the importance of the accounting principles which were contravened, an attempt will be made to enumerate succinctly some of them. No indication was afforded by the accountants in the reports:

That $46,683,319, or 108% of the sum reported as investment profits of the Founders group during the 1928–1930 period, resulted from intercompany dealings in securities of the group and that a large portion of this sum reported as investment profits was in reality part of the contributed capital of the Founders companies and was not profit at all;

That Founders General Corporation, the wholly owned but unconsolidated subsidiary of American Founders Corporation (which was in turn controlled by United Founders Corporation) carried on extensive trading and distributing operations in the stock of American Founders Corporation and United Founders Corporation resulting in large "profits" recorded by Founders General Corporation, which were actually sums deflected from the contributed capital of the parent companies; and that these sums were later passed back to American Founders Corporation and United Founders Corporation as large "dividends," which in certain years comprised the major part of all dividend and interest income reported by these companies; [80]

That United Founders Corporation realized $5,619,384, or 69% of its total dividend income for the 1929 period through the device of a "mock" sale to an affiliated company of "rights" which had been received by United Founders Corporation from another affiliated company; [81]

That a similar "mock" sale was arranged in order to retain an intercompany profit which otherwise would have had to be eliminated in the consolidated financial statement of American Founders Corporation; [82]

That, in order to conceal losses in excess of $14,000,000 on securities which they desired to dispose of, American Founders Corporation and United Founders Corporation exchanged these securities with affiliates and valued, on their books, the securities received at a sum equal to the cost of securities exchanged—a value which was greatly in excess of market value—while simultaneously these vendor corporations deducted the full amount of the "loss" on these securities in their income tax returns; [83]

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ployed, concludes in the following language: "the accompanying balance sheet and related statement of income and surplus fairly present, in accordance with accepted principles of accounting consistently maintained by the company during the year under review its position at (date) and the results of its operations for the year." (See *Papers on Accounting Principles and Procedure,* presented at the 51st annual meeting of the American Institute of Accountants, pp. 75–96; and public testimony of expert witnesses before the Commission, *In the Matter of McKesson & Robbins, Inc.*) On October 18, 1939, the American Institute of Accountants in a bulletin entitled "Extensions of Auditing Procedure" published a revised recommended form of certificate, approved by the Council of the Institute, which concludes as follows:

> In our opinion, the accompanying balance-sheet and related statements of income and surplus present fairly the position of the XYZ company at (date), and the results of its operations for the fiscal year, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

[80] See infra, p. 2296.

[81] See infra, p. 2319.

[82] See infra, p. 2280.

[83] See infra, p. 2335.

That, in an instance when this accounting policy on exchanges would have resulted in elimination of a profit, a "mock" sale was made to a friendly broker and the profit was then reported; [84]

That 65% of the investment profits of International Securities Corporation of America in 1928 and 1929 were realized from investments which violated the widely advertised restrictions of that corporation's bylaws and trust indentures; [85]

That American Founders Corporation "revalued" its portfolio holdings on the basis of appraisals of future earnings, and thereby created paper profits of $11,000,000 which it set up in an "unrealized profits" account from which stock dividends were paid to its stockholders; [86]

That "Surplus" was overstated by $24,000,000 through the device of charging out stock dividends at an arbitrary figure considerably below the paid-in value of the shares issued; [87]

That financing costs were concealed by charging them to "capital surplus account," the composition of which was not divulged; [88]

That the capital surplus account of American Founders Corporation was inflated more than $7,000,000 by shifting to it that amount from "preferred stock account," without any disclosure of this shift; [89]

That payments in excess of $1,000,000 were made during 1930 in settlement of threatened stockholders' suits, which payments were completely concealed from stockholders.[90]

The materiality of these omissions in the reports of the Founders companies was such that a registration statement containing financial statements characterized by equivalent omissions would certainly not comply with the requirements of the Securities Act of 1933 and the Securities Exchange Act of 1934. But, as has been recently pointed out,[91] "despite the Securities Act and the Securities Exchange Act, corporate reports to stockholders remain unregulated to any effective degree," and there is consequently no assurance that stockholders of investment companies could not be or are not today similarly misled.

It is not intended to infer that the onus for these concealments rests solely on the accountants, and that the Founders management is excluded therefrom. On the contrary, it is apparent that the responsibility of those who comprised the Founders management for these abuses is primary and not susceptible of divestment. This report is primarily concerned, however, with the failure of stockholders and the investing public to receive protection against the misfeasance of management. This protection the Founders stockholders were led to believe they would receive from the reputable accountants whose

[84] Ibid.

[84] See infra,, p. 2344.

[86] See infra, p. 2374.

[87] See infra, p. 2381.

[88] See infra, p. 2395.

[89] Ibid.

[90] See 3, infra, p. 2399.

[91] Kaplan and Reaugh, Accounting, Reports to Stockholders, and the SEC, (1939) 48 Yale Law Journal 935. As the authors there state, the Securities Act of 1933 does not embrace securities already issued, or subsequent dealings in securities issued in compliance with its provisions. While the Securities Exchange Act of 1934 does require that periodic reports be filed with the Commission and the exchanges by corporations whose securities are listed on national exchanges or which fall within the purview of Section 15 (d) of that Act, even such corporations are not expressly required to follow Commission standards in their reports to stockholders, and a large percentage of existing corporations do not come within the purview of the Act.

names, signatures, and certificates adorned the reports received by stockholders.

Unlike some other cases in which accountants have failed to protect stockholders and the public from management depredations,[92] no claim was made by the accountants for the Founders companies that they had been duped or misled by the management with respect to the important subjects which they did not reveal to the stockholders. Instead, they rested their defense for failure to disclose principally on the contention that there was no duty on the part of accountants to make disclosure of such situations under the accounting conventions in effect at that period. In some instances they went further and asserted that there would confront them even today no obligation to act otherwise.[93]

It is recognized that opinions in the accounting profession on the subject of sound accounting practices have been further crystallized in the last decade and that practices which are today disapproved with substantial unanimity may have, ten years ago, admitted honestly of varying courses. But the broad principles of truthful disclosures embodied in the axioms postulated above, were no less true in former years than they are today. It has always been a verity that one on whom the duty rests to speak the truth may not lead the listener to a false conclusion by partial disclosure or by artful statement.[94] The doctrine of *caveat emptor* may once have been the rule of the market place, but it was never thought to be applicable to the profession of the public accountant.

It is not without significance in view of the failure of stockholders to receive from the accountants the protection which the Founders management clearly intimated investors could expect from this source, that the Founders management, for its part, was quick to disavow responsibility for fault, claiming for itself, as a result of the employment of the accountants, a protection which the stockholders in their sphere failed to receive. Instancing this management disclaimer is the following excerpt from the testimony of Louis H. Seagrave:[95]

Q. And with so large a proportion of profits indicated in the securities of the group it never occurred to you at that time that it was important that that should be separately stated in the reports to the stockholders?

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[92] For example, the recent case of McKesson & Robbins, Inc.

[93] See, for instance, testimony of W. Homer Conkling of the firm of Loomis, Suffern & Fernald that even today he would not feel that any different course would have to be followed by accountants than was followed in the case of the "mock sale" to D. H. Silberberg & Co., described infra, p. 2302.

[94] The language of Lord Halsbury, referring to an equivocal prospectus issued under the early British Companies Act in the case of *Aaron's Reefs, Ltd.* v. *Twiss* (A. C. 273, 1896) may be found apposite. In answer to the argument that no specific allegation of fact was proved to be false, the Lord Chancellor stated:

> I do not care by what means it is conveyed—by what trick or device or ambiguous language: All these are expedients by which fraudulent people seem to think they can escape the real substance of the transaction. If by a number of statements you intentionally give a false impression and induce a person to act upon it, it is not the less false although if we take each statement by itself there may be difficulty in showing that any specific statement is untrue.
>
> In another case involving accountants (*In re London and General Bank* (*No. 2*), 2 Ch. Div. 673 [(1895)]) the court stated: "A person whose duty it is to convey information to others does not discharge that duty by simply giving them so much information as is calculated to induce them, or some of them, to ask for more.

[95] Public Examination, American General Corporation, et al. at 24118. Mr. Seagrave was president of American Founders Corporation and United Founders Corporation and was one of the three individuals comprising the inner-management group.

A. I would say again that it did not. I was not an auditor; I relied upon the auditors we engaged for the purpose, and the way they set it up I thought was correct.

Q. So that it was for the auditors to say whether or not that was good or bad from your point of view?

A. It certainly was.

Q. If they passed it, that was all right with you?

A. It certainly was.

Frank B. Erwin, president of Founders General Corporation and another one of the three individuals who comprised the inside management group, testified to like effect: [96]

Q. For your information, Mr. Seagrave stated that so far as the presentation of these reports was concerned they depended absolutely on the accountants, and if the accountants would have told them to break the items down they would have been glad to do it. And that would be your statement too, that when these came with the signature of a certified public accountant affixed to them and even though your individual ideas may have been different you said, "Well, if that is the standard form I understand it, and I can tell people if they ask me, but if this is the way they want it to go out it is all right with me."

A. Yes, that would be my answer to it.

No final evaluation of the role played by the independent public accountants in the deception of the Founders' stockholders and the investing public, no explanation for the acceptance of such a role by reputable public accountants, is possible without coming face to face with one persistent and pervasive question whose significance transcends the limits of the present report: Without in any way impugning the integrity of the accounting profession, how much untrammeled independence can realistically be expected of "independent" public accountants whose hire, compensation, and tenure of employment all rest, not with the stockholders or directors independent of the management group acting under appropriate safeguards, but with the very management group on whose conduct of the business as reflected in the financial statements these accountants are expected to report for the benefit of stockholders? [97]

6. "LUMPING" THE ACCOUNTS

The manner in which the various concealments and accounting malpractices enumerated above were effected is discussed in the body of

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[96] Id., Commission's Exhibit No. X3737, p. 172. Donald C. Wheaton, director of several of the companies of the Founders group, testified that the directors likewise relied on the accountants. He stated (id., at 23137):

> * * * The point was that we were given these figures, and we assumed that the form in which the auditors and counsel approved it to go out was all right, and we agreed to it then. In the light of subsequent developments I would say today earnings statement should be broken down * * *.

[97] Some approach to the problems implicit in this question has been made by the British Companies Act of 1929 and the Australian Companies Act of 1938. The British Act in addition to providing that auditors shall be appointed by the shareholders and shall report to them (Sections 132 and 134) stipulates that the Board of Trade may appoint one or more competent inspectors to investigate the affairs of the company, on the application of members holding not less than ten percent of the number of shares issued, and the showing of reasonable cause (Section 135). Moreover, the shareholders themselves, may, by special resolution, appoint such inspectors (Section 137). The Australian Act contains similar provisions (Sections 132, 136, 137). Furthermore, it is provided by the Australian Act that no one may be appointed an auditor by the company who is a director or employee of the company or a partner or employee of a director or employee, or who is or becomes

this section of the chapter in conjunction with the transactions to which they relate. It will there be seen that the device most frequently employed was that of "lumping the accounts"; that is, of embracing within one broad heading a miscellany of items, more or less related, although each item has an individual significance of its own which should be disclosed if an accurate picture is to be presented.[98] "Lumping" may be confined to the income statement, or it may also be extended to the balance sheet, affecting assets, liabilities, or surplus account items.

In the course of this report, it will be shown that "lumping" characterized all these phases of the Founders' published financial statements at various times. The first part of the present report is concerned primarily with "lumping" in the income statement, and in the second part consideration is given largely to treatment of the surplus accounts.

The importance of the income statement for the stockholder has of late years been well understood. It is in large measure to the income statement that the stockholder turns in his search for that which is increasingly recognized as a primary concern—evaluation of the prospective net earning power of the corporation.[99] It was precisely in the income statements that the accountants and the management of the Founders Companies practiced "lumping" in its severest form.

Commencing with the year 1926 and extending until the end of 1928 all income received by the various Founders companies was lumped into a single broad category and reported in the published income statement as a lump sum figure under the heading "interest, dividends, and investment profits." A statement set forth in this manner obviously failed to reveal to the reader the following pertinent information:

(a) The amount of the lump sum figure which was received as ordinary income—income in the form of interest and dividends, which, in the case of an

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indebted to the company in an amount exceeding £250. (Sec. 132 [7]; for somewhat similar provisions of the British Act see Sec. 133.)

[98] "Itemization within these major categories of income is an essential minimum of income disclosure. An investor is not interested merely in learning the total earnings for the current year which an indivisible total gives him; his primary interest in earnings is based, to a large extent, on the ability it gives him to forecast the future. Total figures must be broken down to enable him to obtain some information as to the sources of past income in order that his guess as to the future, precarious at best, is something more than a wild shot in the dark." (Kaplan and Reaugh, op. cit. supra, note 91, p. 944.)

[99] See Kaplan and Reaugh, op. cit. supra, note 91.

"Accountants and investment analysts today are agreed that the income statement is much more significant and informative to the investor than the balance sheet. The balance sheet is a highly technical document, as will be seen later, of relatively small value to one who wants to decide to buy or sell securities. It does not purport to give an investor *present values;* it merely reports that portion of historical and current disbursements which remain, after depreciation, obsolescence, depletion and amortization have been charged periodically to the fiscal periods in which the capital assets are assumed to have been consumed. The income statement, however, is of cardinal importance, as the 'value' of a business depends, not on the historical costs incurred in the process of building it up, but upon its earning capacity." See also Graham and Dodd, *Security Analysis* (1934), pp. 299–313 for a discussion of the shift in emphasis by investors from the net worth of a business to the earning capacity.

It may be that the statement above quoted underestimates the importance of the balance sheet in general; and in the case of investment companies must receive a more limited application than would be true of an industrial company, with large fixed asset accounts. Nevertheless, for stockholders of investment companies too, the income statements are of cardinal importance.

investment company, would presumably represent a recurrent item, as distinguished from the amount received in the form of investment or trading profits—income which, for an investment company, cannot be deemed ordinary or presumptively recurrent.[100]

(b) As to both classes of income, the proportion, if any, which was received from companies affiliated with the recipient company. This information in the case of interest and dividends would serve to disclose the extent to which the corporation's ordinary income was derived from companies closely related to it and subject perhaps to the same business hazards; and in the case of investment profits it would serve to disclose the amount derived from or through affiliated companies, which might have permitted the reporting company to gain a profit essentially gratuitous in nature and in a manner inconceivable where companies are unrelated and dealing at arm's length. It would then be open to question whether the reporting company was entitled to enter in its income account sums which were essentially nothing more than portions of affiliated companies' capital, contributed by an unsuspecting public.[101]

(c) The amount of the lump-sum figure, if any, representing profits of such unusual nature, apart from the considerations discussed above, requiring that they be set forth separately, with details explaining the extraordinary character, so that the nonrecurrent and extraordinary nature of the item might be understood, and the investor not misled in calculating the normal earning power of the corporation.

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[100] The abnormal character of investment profits in the case of investment companies has long been recognized in this country and abroad. In 1931, a special committee of the New York Stock Exchange reported as follows concerning the need to segregate investment profits from normal income in the case of investment companies:

> Such gains and losses [on portfolio securities] are more closely related to the unrealized appreciation or depreciation of the portfolio than to the current dividend and interest income. If this procedure is followed, investment trust reports will be more informative to investors, in that the income account will then clearly set forth merely the net result as between current income and current outgo, and this information, separated from security profits, is of particular value to holders of prior securities bearing a fixed rate of return. Furthermore, there would thus be eliminated any basis for the illusion that occasional profits realized on the sale of securities form a proper basis for increasing continuing earning power.

The Australian Companies Act of 1938 embodies the principle in explicit terms, as follows:

> SEC. 591. (4) The profit and loss account of every investment company shall show separately, in addition to any other matters required by Part I of this Act to be shown therein, income from underwriting (including subunderwriting).
> SEC. 592. (1) All profits and losses of an investment company from the purchase and sale of securities shall be respectively credited and debited to a reserve account to be kept by the company and to be called the investment fluctuation reserve.
> (2) The investment fluctuation reserve shall not be available for the payment of dividends.

Even in the absence of statute, British and Canadian investment companies have for many years pursued an almost identical policy to that embodied in the statute above quoted. (See Robinson, *Investment Trust Organization and Management,* revised ed., 1929, p. 366.) At the public hearing before this Commission, Dr. Robinson stated: (Public Examination, American General Corporation, et al., at 25000):

> Obviously any earning statement which includes any profits, whether segregated or not, is misleading because profits in the very nature of the case are not recurrent. The question is whether they are ever included in income. They have no right to be there.

[101] In the case of the Founders companies it will be seen that this type of artificial "profits," which were not profits at all but conversions of affiliates' capital, played a vital role in the deception of stockholders and the public. Although some of the former Founders' officers sought to defend the astounding "profits," which frequently equaled 100% to 200% of cost, as "underwriting" profits (in the reports they were set forth as "profits on investments"), it is noteworthy that Leland Rex Robinson, formerly president of Second International Securities

(Footnote [101] continued on p. 2247.)

Commencing with the year 1929 the practice of "lumping" the income account was modified, to the extent of eliminating the first of the three objections set forth above; income from interest and dividends, profits on sale of investments, and other types of income were separately stated. No change was made, however, with respect to the second or third objections described above; no indication was given in respect of the various types of income as to the proportion of each type of income which was derived from affiliated companies; nor was indication given as to amount of the income which was attributable to extraordinary items. An actual or prospective stockholder scrutinizing the profit and loss statement of a Founders company and noting the substantial profits reported, did not receive the slightest intimation that these profits were of an unusual or unstable character. Having read the statement of the president of the company prefacing the report concerning the Founders' investment technique, its international trading, and its superlative research department,[102] in the absence of any indication to the contrary, the stockholder was left to assume that these profits represented the natural produce of the company's activities as described earlier in the report.

It is to be noted that while the stockholders of the Founders companies were receiving "lumped" reports which concealed from them the true nature of the income reported by their companies, the Founders management received from the accountants for their private perusal, itemized reports which revealed the details withheld from stockholders. For example, in the report to the stockholders of

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Corporation and an officer of many other Founders Companies, the author of the book, *Investment Trust Organization and Management,* was outspoken at the public examination before this Commission in condemning such "profits" and in advocating that they be prohibited. In this regard, Dr. Robinson testified (Public Examination, American General Corporation, et al., at 25000–1):

> Q. Doctor, as far as profits that come from the trading or sale of securities of the Group that should be separately stated from other income?
> A. That should be separately stated from other income, and I would go further and say any such thing should be completely disallowed. I don't believe in underwriting profits having any connection with associated or affiliated companies. They are entirely out as far as I am concerned. I say that despite the fact we made a huge profit in 1929 as a result of it and carried a large part of it forward in actual profits. In other words, it was a profitable thing.

At a subsequent point, Dr. Robinson summed up his views with respect to the distribution methods of the Founders companies as follows (id., at 25005): "Mr. Stern, I disapprove of the whole damn business * * *." (For detailed testimony by Dr. Robinson, see infra, p. 2362.)

At least one country, Australia, has definitively solved the complex problems growing out of affiliations between investment companies by prohibiting such relationships altogether. The Australian Investment Companies Act of 1938 provides:

> SEC. 589. No investment company shall purchase or hold any shares in or debentures of (a) any other investment company; * * *.

In addition, it is provided that:

> SEC. 586. (1) No investment company shall invest an amount greater than ten percentum of the paid-up share capital of the investment company in any one company.
> (2) No investment company shall hold more than five percentum of the subscribed ordinary share capital of any one company.

[102] See excerpts, supra, and Appendix Q.

American Founders Corporation for the fiscal year ended November 30, 1927, the income for the year was stated tersely as follows:[103]

Interest, dividends, realized investment profits, and other income	$2,829,093.30

In contrast, the income statement received by the management stated:[104]

Interest and dividends:		
On investments	$444,701.08	
On balances with banks and bankers	48,164.64	
On loans, notes receivable, and accounts receivable	17,478.19	
		$510,343.91
Realized investment profits:		
On sales of "option" shares, International Securities Trust of America	340,210.41	
On sale of Class "B" shares, International Securities Corporation of America	692,612.67	
On securities in general portfolio	902,119.28	
Profit on trading in own shares	148,196.01	
		2,084,138.37
Other income:		
Investment service fees	199,891.20	
Syndicate commissions	25,598.90	
Other commissions	2,841.45	
Profit on foreign exchange	6,279.47	
		234,611.02
		2,829,093.30

From the statement received by the management it was apparent (a) that only $510,343 out of the total reported income of $2,829,093 was ordinary income; (b) that $1,032,822 of a total of $1,934,941 resulted from nonrecurrent transactions in the securities of closely affiliated companies; (c) that $148,196 additional of "investment profits" was the result of trading by the corporation in its own shares. This information, whose importance was obviously clear to both the accountants and the management, was withheld from the stockholders. Nothing in the report the stockholders received contained the slightest intimation that the sum of $2,829,093 reported as their corporation's income had to be accepted with caution. This contrast between the information supplied to the management and that supplied to stockholders is typical of the practice followed by the management and the accountants during the period under consideration.[105]

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[103] Public Examination, American General Corporation, et al., Commission's Exhibit No. X3466A.

[104] Id., Commission's Exhibit No. X3466.

[105] For numerous other examples of itemized reports rendered by the accountants to the management during the years 1928, 1929 and 1930; see id., Commission's Exhibit No. X3831.

Louis H. Seagrave, president of American Founders Corporation, when questioned with respect to the meagerness of the information accorded to stockholders, replied that "the auditors had supplied the management with that statement and form of the report to the stockholders" and, "I think that the management of a company that engages auditors and certified public accountants to examine their books, to prepare a statement, ought to be able to rely upon that statement and send it to their shareholders."[106] Conflicting with Mr. Seagrave's version, Leland Rex Robinson, president of Second International Securities Corporation, revealed that the form of the report sent to stockholders was the subject of much discussion and considerable disagreement between the directors and the management. Dr. Robinson claimed that he had favored segregation and itemization in the income account but that "others didn't" and that he himself had failed "to push for it as strong as I should." Dr. Robinson testified in this regard:[107]

Q. * * * You also in your book made perfectly clear, and this, Doctor, is particularly relevant in the case of your company. In your book you have made it perfectly clear that in England the investment profits were not treated

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[106] Mr. Seagrave's testimony was as follows (id., at 22910 et seq.):

Q. You will observe that in the annual report (to stockholders) there is some discussion of the earnings of the Trust, but there is no reference in this discussion to the fact that the income and profits are all lumped together in the figure of $2,829,000?

A. That is right.

Q. And that of that figure, as appears from Exhibit 3466, the report of Messrs. Clarke, Oakes & Greenwood, to the management, $2,084,000 represents profits from trading in securities.

A. That comes from the statement of income in the report certified by Clarke, Oakes & Greenwood.

Q. Does not it seem to you, Mr. Seagrave, that where you are discussing earnings, devoting a whole half page to the discussion of earnings that it might have been well to have taken your stockholders into your confidence and to have pointed out that five-sevenths of the income was profit from trading in securities, and that of that five-sevenths, or $2,000,000, $1,033,000 came from the sale of option shares and from the sale of Class B shares, $148,000 came from the profit in trading in its own shares, and only $900,000 came from the trading in securities in the general portfolio? Don't you think it would have given quite an accurate picture to your stockholders?

A. Mr. Stern, you pointed out a number of times here that that is what we did at that time. It seemed all right at the time. Today I would certainly break up these income statements. That is the only answer that I can give you on that question. I am convinced today that it would be preferable to break up the income statement and to point out any unusual features, but at the time it did not seem to be the practice; it was not recommended or urged upon us by the auditors. The form of the report that they gave to us did not include it, and we went on that way. Then it came that it was thought better to do it the other way, and we began doing it the other way. That applies to all of these companies.

Q. The thing I should like to know is, where you have an extensive discussion of this in the auditor's report, there should be so slight a reference to this in the annual report. Is that the way the auditors presented it to you, Mr. Seagrave, for publication in the annual report?

A. Mr. Stern, I think in all the reports of this group the auditors supplied us with a statement and form for the report. Sometimes they gave us a detailed letter to directors. It was never the intention, nor was it ever urged by the auditors, that these reports, with the comments and details should be sent to the stockholders. It was not the custom of the time, and it is not even today, as far as I am aware. This is the way the auditors gave it to us, and this is the way we published it.

Q. Mr. Seagrave, then do I take it that you think the responsibility for this kind of statement is really upon the auditors or the company?

A. I think that the management of a company that engages auditors or certified public accountants to examine their books, to prepare a statement, ought to be able to rely upon that statement and send it to their shareholders. I think that the things that auditors did years ago have gradually been changed. I know that they do give far greater detail than they did in the olden days. I think there has been a growth of appreciation of what probably should go in these reports. Therefore, it is just impossible to look upon today what was being done then.

Q. Then in any event you think that the auditors furnished you with this condensed statement of income and profit and loss shown on page 18, and that having employed certified public accountants you were entitled to send that to the public?

A. Yes.

[107] Id., at 24997, et seq.

the same as income. You knew that and you knew it was a conservative practice, rather more conservative than the American practice, but you pointed out that profits must be treated separately from other income.

A. That they should be.

Q. That they should be. You also gave a form of income statement in your book which shows profits treated separately from other income.

A. Yes, sir.

Q. And that was based upon financial grounds so well known we need not pass on them?

A. Yes, sir.

Q. But when it came to giving a report of Second International, you didn't do that?

A. Not prior to 1929.

Q. Why was that? Your accountants did make the separation for you? Why didn't you in your report separate it?

A. We should have done so. There was considerable disagreement among us as to whether we should do it or not. I wanted to see it done. Others didn't.

Q. Who were those that didn't want to see it done?

A. I would rather not mention names, please.

Q. Were they your fellow directors?

A. A number were. They thought there was no necessity for it, nor did I push for it as strong as I should. I take a considerable amount of blame myself as I look back. I don't understand how it could be. I think I should have insisted upon it, but between the ideal and the actuality there is always a very large gap, and it was certainly something I was moving toward and anxious to have done * * *.

The extent to which the stockholders were misled as a result of this "lumping" of the income account, will now be discussed in detail. The period under consideration is, as has been stated, the period of full maturity of the United Founders Corporation System, the years 1928, 1929, and 1930.

B. Accounting Malpractices and Concealments in Relation to the Income Accounts

1. FAILURE TO SEGREGATE AND REVEAL SUMS RECEIVED FROM DISTRIBUTION TO PUBLIC OF THE GROUP'S SECURITIES AND PLACED IN INCOME ACCOUNTS

Lumped in the income accounts of the companies of the United Founders Corporation group for the period 1928–1930 were, as has been stated, "profits" in the amount of $46,683,319 which were "realized" by the Founders companies exclusively from intercompany dealings [1] in their own security issues and in the issues of Founders affiliates. These "profits" are itemized and tabulated by year and by company in Appendix A.

[1] It is emphasized once again that the term "intercompany" dealing or transaction is not used in this report in its most technical sense, but is used broadly to characterize transactions between two or more Founders companies which resulted in an immediate gain to one of them, even though a sale was subsequently made to the public to complete the transaction.

It has been stressed in the previous section, for reasons which the details set forth in this and subsequent sections will make clear, that these sums were fundamentally not profits at all, but reallocations of the contributed capital of the companies of the group; nevertheless, for the sake of simplicity they will be referred to generically in the following pages as "profits," while at the same time their true character is exposed.

Intercompany dealings by the Founders companies in their own securities and in those of their affiliated companies during the period under consideration present a variform pattern. First, there were dealings by the underlying companies of the Founders Group [2] in the securities of the two top holding companies, American Founders Corporation and United Founders Corporation. Profits derived from dealings of this nature may be termed "downstream profits" because the direction of movement is from above downwards.

In contrast to the first category were transactions by the two top companies, American Founders Corporation and United Founders Corporation, involving the securities of the various underlying companies. Profits realized from transactions of this type may be referred to as "upstream profits."

Another class of profits which may be called "criss-cross profits" was realized by various of the underlying companies from dealings in the securities of the other underlying companies.

Still another class of profits termed "circular profits" was recorded through a series of intercompany transactions involving a block of Founders securities in which each successive holder extracted a "profit," the stock ultimately returning to the portfolio of the original seller at a "cost" many times that which it formerly had.

A fifth class of profits was derived by Founders Group companies from dealings in the securities of companies which were not "members" of the Founders Group, but which were sponsored by the Founders Group and were listed by it as "affiliates."

Finally, there were the profits realized by Founders General Corporation, distributor of the securities of the group, from extensive dealings in the stock of the two top companies, American Founders Corporation and United Founders Corporation. By virtue of the fact that Founders General Corporation was a wholly owned subsidiary of American Founders Corporation, which in turn was directly controlled by United Founders Corporation,[3] the sums received in the form of dividends by the latter two companies from Founders General Corporation constituted, in large measure, funds obtained by these top companies from distributing their own securities, which funds instead of going into the capital accounts of the corporations were instead treated by them as income.

Not all intercompany transactions engaged in by the companies of the United Founders Corporation group are susceptible of neat classification; some of them do not fit into any of the categories enumerated above, while others combine elements of several of these categories.

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[2] By "underlying" Founders companies are meant those companies which became in 1929 direct subsidiaries of American Founders Corporation, namely, International Securities Corporation of America, Second International Securities Corporation, United States & British International Company, Ltd., and American & General Securities Corporation.

[3] See supra.

Nevertheless, the foregoing groupings may prove of service in picking a path through the numerous and varied transactions now to be considered in some detail.

a. Nondisclosure of Sums Diverted to Income Accounts of Founders Companies through Device of Gratuitous Options

The income accounts of the Founders companies for the fiscal years 1928 and 1929 included the sum of $5,166,507 garnered by the underlying Founders companies [4] without outlay of any money or assumption of risk or obligation of any kind. These profits were realized by the underlying companies through the exercise of gratuitous options to purchase the stock of the two top companies, American Founders Corporation and United Founders Corporation. Although these profits were, as will be seen, of such an extraordinary nature that there was little to distinguish them essentially from outright gifts, nevertheless they were neither segregated nor otherwise identified in the financial reports of the recipient companies. As a consequence, the reader of the report was led to infer that the profits resulted from the Founders companies' skilful operations on international markets through the use of their vaunted "investment technique" and the guidance of their research division.

The first instance of this type of profit occurred late in 1928 and arose out of the following circumstances. On August 2, 1928, Founders General Corporation, the wholly owned subsidiary of American Founders Trust, agreed to purchase from American Founders Trust 25,000 shares of the latter's newly issued common stock at $100 a share.[5] On the following day, August 3, 1928, Founders General Corporation gave options to International Securities Corporation of America, Second International Securities Corporation, and United States & British International Company, Ltd., to buy, respectively, 17,500 shares, 4,000 shares, and 3,500 shares, of this stock of American Founders Trust at the price of $100 a share.[6] The several Founders companies paid nothing for these options.[7] In October 1928 American Founders Trust, theretofore a Massachusetts common law trust, commenced functioning as a Maryland corporation, and at the same time its common shares were split two for one,[8] so that the 25,000 shares covered by the options became 50,000 shares and their price was reduced from $100 to $50 a share.

In October and November 1928, the closing months of the fiscal year, the three Founders companies exercised their options and simultaneously instructed Founders General Corporation to sell for their respective accounts the shares thus obtained. Founders General Corporation sold the 50,000 shares at prices averaging from $60.96 to $66.69 a share for a total of $3,162,960.51. This amount exceeded their cost of $2,500,000 by $662,960.51.[9] Founders General

[4] See note 2, supra.

[5] Public Examination, American General Corporation, et al., Commission's Exhibit No. X3604.

[6] The fourth underlying company, American & General Securities Corporation, was not formed until October 1928.

[7] Op. cit. supra, note 5.

[8] Id., Commission's Exhibit No. X3404.

[9] Id., Commission's Exhibit No. X3847.

Corporation remitted to each of the three Founders companies its share of the excess above the option price of $50 a share,[10] which they recorded as "investment profits," as follows: [11]

International Securities Corporation of America	$458, 420. 63
Second International Securities Corporation	87, 714. 25
United States & British International Company, Ltd.[12]	116, 825. 63

The facile "profits" of $662,960 recorded by the underlying Founders companies in 1928 through options on the stock of American Founders Corporation, in the manner described above, were dwarfed by the equally facile profits reaped by these companies in 1929 through similar options on the stock of the newly organized United Founders Corporation. From these options on the stock of United Founders Corporation, "profits" of $4,215,472.12 were realized and reported in the income accounts of the underlying Founders companies.[13]

The details of the transactions by which these substantial profits were derived were as follows:

United Founders Corporation was incorporated on February 2, 1929.[14] On February 5, 1929, its board of directors authorized, as the initial issue of its common capital stock, 2,400,000 shares at a price of $10 a share upon the basis of an exchange for the securities of companies of the Group, and at a price of $10.50 a share upon a cash basis, "to such persons, firms, or corporations as the officers (president and treasurer) may determine." [15] Out of this initial authorization 205,000 shares were allotted to four of the Founders companies by way of the following intermediate steps. The shares

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[10] Id., at 23027.

[11] Id., Commission's Exhibits Nos. X3847 and X3732.

[12] Louis H. Seagrave, president of American Founders Corporation, when questioned concerning these transactions, testified (Id., at 23029–30):

> Q. And that profit, according to the schedule * * * Exhibit 3732 * * * was for I. S. C. A., $458,420.63, Second International, $87,714.25, U. S. and B. I., $116,825.63, a total of $662,960.51 * * *. Mr. Seagrave, as you look upon it today, do you think that a good arrangement, for a corporation that has its own stockholders to turn over a possible profit to corporations that have different stockholders, when it is not under any obligation to do it?
>
> A. No, I don't like that arrangement very well; I don't believe I would approve it today. I think it would be far better not to have transactions of that kind.

Portions of the allotments of International Securities Corporation and of Second International Securities Corporation were sold to Investment Trust Associates, a newly acquired Founders company. International Securities Corporation of America sold to Investment Trust Associates 10,000 shares of its allotment of 35,000 shares at $67.50 a share, a profit of $17.50 a share, or a total profit of $175,000. Second International Securities Corporation sold 7,000 out of its total of 8,000 shares to Investment Trust Associates at $60 a share, a profit of $10 a share, or $70,000. Thus, $245,000 of the riskless profits realized by the underlying Founders companies was at the expense of another Founders company. This subject will be discussed further in the succeeding section concerning sales from one Founders company to another.

[13] These profits were in the following amounts (op. cit. supra, note 5, Commission's Exhibit No. X3732):

International Securities Corporation of America	$1, 681, 445. 12
Second International Securities Corporation	951, 305. 00
United States & British International Company, Ltd.	793, 465. 00
American & General Securities Corporation	789, 257. 00

Two other Founders companies also reported from these options, as will be shown later. Investment Trusts Associates realized $230,460, and Founders Associates, $57,615. See note 27, infra.

[14] Id., Commission's Exhibit No. X3420.

[15] Id., Commission's Exhibit No. X3667.

first were routed to Founders General Corporation, the distributing agency of the Group. Founders General Corporation then offered these shares at $10.50 a share to the four underlying Founders companies, not in the form of firm commitments, but as options granted without any consideration.[16]

For thirty days, the favored companies, without obligation on their part, had a call on all profits which would accrue from any rise in the market price of these shares above $10.50 a share, the initial issue price.[17]

Eighteen days after receipt of the options, on February 26, 1929, the four Founders companies exercised their options but did not themselves even take down the shares. Instead, they requested that Founders General Corporation arrange to sell the entire block and remit to them the profit realized.[18]

The prices at which these shares were sold ranged from $20 a share to $25.93 a share, the average price being $21.25, or approximately 102% over cost ($10.50 a share).[19]

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[16] The following letter from Founders General Corporation to International Securities Corporation of America dated February 8, 1929 (id., Commission's Exhibit No. X3692) describes these options granted without consideration of any kind to Second International Securities Corporation, United States & British International Company, Ltd., American & General Securities Corporation, as well as to the addressee, International Securities Corporation of America:

FEBRUARY 8, 1929.

INTERNATIONAL SECURITIES CORPORATION OF AMERICA,
1 Exchange Place, Jersey City, New Jersey.

GENTLEMEN: We have arranged to purchase, or cause to be purchased, delivery to be made to or upon our order, an issue of common shares of United Founders Corporation at $10.50 per share. The amount for which we have committed we find to be beyond our immediate requirements.

Confirming our understanding, we now wish to advise that of this commitment we will grant you an option to purchase all or any part of a block of 75,000 shares at the price to us of $10.50 per share, said option to continue for a period of thirty days from the date hereof.

In the event you exercise this option but may not wish to take down and pay for the entire block of shares, we therefore offer you our services, in disposing of them through distribution on the open market or otherwise.

Will you please confirm the foregoing.

Your very truly,

FOUNDERS GENERAL CORPORATION,
(Signed) L. P. GARRON, *Treasurer.*

[17] The confirmation, typical of the other confirmations, was in the following form (id., Commission's Exhibit No. X3692):

FEBRUARY 9, 1929.

FOUNDERS GENERAL CORPORATION,
50 Pine Street, New York, New York.

GENTLEMEN: We acknowledge receipt of your letter of February 8, 1929 and accept the option granted us to purchase all or any part of a block of 75,000 common shares of United Founders Corporation at $10.50 per share, for a period of thirty days.

If we exercise our option, it is quite likely that we may call upon you to assist in the immediate disposal of these shares.

Yours very truly,

INTERNATIONAL SECURITIES CORPORATION OF AMERICA,
(Signed) FRANK B. ERWIN, *Vice President.*

[18] The following letter is typical of the form in which the options were exercised (id., Commission's Exhibit No. X3692):

FEBRUARY 26, 1929.

FOUNDERS GENERAL CORPORATION,
50 Pine Street, New York, New York.

GENTLEMEN: With reference to your option to us of February 8, 1929 to purchase 75,000 Common Shares of United Founders Corporation, and our acceptance thereof of February 9, 1929, we wish to advise herewith that we desire to exercise this option and to purchase the entire 75,000 shares.

We do not wish to take down these shares and request that you arrange to sell the entire block for our account and remit to us for any profit less expenses.

Your very truly,

INTERNATIONAL SECURITIES CORPORATION OF AMERICA,
(Signed) FRANK B. ERWIN, *Vice President.*

[19] Id., Commission's Exhibit No. X3859.

Thus, in the space of 18 days, without incurring any risk and without having made any investment, merely by the exchange of the letters set forth above, the four companies were presented with sums of money as "investment profits" aggregating $2,198,953.75.[20] If Founders General Corporation had sold these shares directly for the account of the issuer, United Founders Corporation, that corporation would have received approximately $2,200,000 additional of working capital.

Approximately four months after the occurrence of the transactions described above, another series of transactions, similar in nature, took place in connection with the distribution of additional newly issued common shares of United Founders Corporation, as a result of which the four underlying Founders companies recorded an additional sum of $2,016,518.37 as "investment profits." On June 10, 1929, the executive committee of United Founders Corporation authorized the issue of an additional 1,000,000 shares of common stock, and the committee resolved [21]

to sell and dispose of the same to or upon the order of Founders General Corporation, or to such other persons or banking institutions as they may

[20] This aggregate profit is itemized in the following summary (ibid.):

Period of sales	Sold by Founders General Corporation for account of—	Number of common shares of United Founders Corporation sold	Average sales price	Total sales price	Cost at $10.50 per share plus transfer taxes	Proceeds paid over, representing realized profits	Percent of profits upon cost
1929							
Feb.	International Securities Corp. of America.	74,195	$20.611	$1,529,234.25	$782,015.30	$747,218.95	96
March.	International Securities Corp. of America.	805	25.934	20,877.50	8,484.70	12,392.80	147
		75,000	20.668	1,550,111.75	790,500.00	759,611.75	96
Feb.	Second International Securities Corp.	25,000	22.96	574,000.00	263,000.00	311,000.00	118
Feb.	Second International Securities Corp.	25,000	20.00	500,000.00	263,000.00	237,000.00	90
		50,000	21.48	1,074,000.00	526,000.00	548,000.00	104
Feb.	U. S. & British International Co., Ltd.	20,000	23.00	459,200.00	210,400.00	248,800.00	118
Feb.	U. S. & British International Co., Ltd.	20,000	20.486	409,375.00	210,400.00	198,975.00	95
		40.000	21.743	868,575.00	420,800.00	447,775.00	107
Feb.	American & General Securities Corporation.	20,000	23.00	459,200.00	210,400.00	248,800.00	118
Feb.	American & General Securities Corporation.	20,000	20.25	405,167.00	210,400.00	194,767.00	93
		40,000	21.625	864,367.00	420,800.00	443,567.00	106
	Totals	205,000	21.253	4,357,053.75	2,158,100.00	2,198,953.75	102

[21] Id., Commission's Exhibit No. X3860.

determine from time to time, in such lots of shares and at such prices as they may be able to effect the sale of; provided, however, that the minimum price to be received therefor by this corporation shall be at least the sum of $35 flat per share, such price to be not more than one and one-half points less than the amount obtained by the Founders General Corporation.

The committee resolved also that 200,000 of the 1,000,000 shares be held under option to Founders General Corporation at $41 a share, in consideration of Founders General Corporation's agreeing to undertake the distribution to the public of the remaining 800,000 common shares of United Founders Corporation.[22] But it was made an express condition of this option agreement that any profits arising from the sale of the 200,000 option shares by Founders General Corporation be divided among "affiliated companies" of American Founders Corporation after allowing one and one-half points to Founders General Corporation as a selling commission.[23] Accordingly, Founders General Corporation granted options to the several Founders companies for the acquisition of 200,000 shares at the stated price of $41 a share.[24]

The several options were exercised in June and July 1929.[25] Founders General Corporation disposed of the 200,000 option share lot at an average price of $54.063 a share. Since the option price was $41 a share, there was a profit of $13.063 a share,[26] which was approximately 32% of cost.

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[22] Id., Commission's Exhibits Nos. X3860 and X3698.

[23] Ibid.

[24] The following offer of the option by Founders General Corporation to International Securities Corporation of America, and its acceptance by International Securities Corporation of America, is typical of all the others (id., Commission's Exhibit No. X3698) :

Telephone John 6014

FOUNDERS GENERAL CORPORATION

Controlled by American Founders Corporation

FIFTY PINE STREET, NEW YORK JUNE 10, 1929.

INTERNATIONAL SECURITIES CORPORATION OF AMERICA,
1 Exchange Place, Jersey City, New Jersey.

DEAR SIRS: Referring to our discussion of last week with you, we beg to advise you that United Founders Corporation has this day authorized the issuance of 1,000,000 additional shares of Common Stock, the sale of which we are undertaking.

In consideration of undertaking the sale of this stock, United Founders Corporation has granted us an option on a portion of this stock. We hereby grant you an option, good for sixty (60) days from the date hereof, to purchase 80,000 shares of United Founders Corporation Common Stock, at a price of $41 per share net, the same price at which the option is offered to us.

Should you exercise this option and later desire to dispose of the shares, we shall be glad to undertake the sale thereof through our organization in consideration of a commission of one and one-half (1½) points per share.

Yours very truly,

FOUNDERS GENERAL CORPORATION,
By (Signed) FRANK B. ERWIN, *President.*

Resources over $55,000,000.

INTERNATIONAL SECURITIES CORPORATION OF AMERICA
ONE EXCHANGE PLACE, JERSEY CITY, N. J.

JUNE 10, 1929.

FOUNDERS GENERAL CORPORATION,
50 Pine Street, New York City.

DEAR SIRS: We thank you for permitting us to participate, to the extent of 80,000 shares, a $41 per share net, in your commitment of the Common Stock of UNITED FOUNDERS CORPORATION, and hereby accept the option tendered us in your letter of June 10, 1929, such option being good for sixty (60) days from the date hereof.

We thank you for your offer to dispose of these shares for us through your selling organization at a commission of one and one-half (1½) points per share in the event that we should exercise our option and desire to dispose of the shares.

Yours very truly,

INTERNATIONAL SECURITIES CORPORATION OF AMERICA,
By WILLIAM R. BULL, *President.*

[25] Id., Commission's Exhibit No. X3699.

[26] Id., Commission's Exhibit No. X3861.

In accordance with the option arrangement there was due Founders General Corporation $1.50 a share as commission. There was also a deduction of four cents a share for transfer stamps. There remained $11.523 a share to be paid the beneficiaries under the option agreements. In July 1929, these beneficiaries received their respective shares of the net profits, which aggregated $2,304,593.37.[27]

These various sums presented to the underlying Founders companies were treated by the companies as "investment profits," and were reported without identification or comment, as has been stated, under the inscrutable heading "interest, dividends, and investment profits."

W. H. Conkling, a member of the firm of Loomis, Suffern & Fernald, public accountants, who were auditors for the several Founders companies participating in these extraordinary profits, conceded that "today" there would be segregation of such "profits":[28]

Q. We have the case that nobody approves, of who has testified here, of one of the companies subscribing for a certain number of shares and then giving an option to the subsidiary companies, say, for 60 or 90 days, to take those down; the subsidiary companies did take them down and make substantial profits. Of course the subsidiary companies stood only to win, they couldn't lose in that situation. They had no obligation; all they had to do was to watch the market and when the market got to a certain price, exercise their option, which they did. Those profits went into their income account. I take it that, at least, would be clearly shown in any statement that you would get out today?

A. I think any statement that you would get out today there would probably be a note to the income account making some reference to it.

Q. As I recall, you stated yesterday, Mr. Conkling, that you would subdivide it today in the annual reports showing separately profits from sale of securities and you would further subdivide profits by showing intercompany transactions separately, or transactions between the companies separately.

A. Yes.

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[27] These profits were paid out to the respective companies as follows (id., Commission's Exhibit No. X3861):

	Number of shares allotted	Net amount received, representing realized profits
International Securities Corporation of America	80,000	[a] $921,833.37
Second International Securities Corporation	35,000	403,305.00
U. S. & British International Company, Ltd.	30,000	345,690.00
American & General Securities Corporation	30,000	345,690.00
Total	175,000	2,016,518.37
Investment Trust Associates	20,000	230,460.00
Founders Associates	5,000	57,615.00
Grand Total	200,000	2,304,593.37

[a] This profit of $921,833.37, as well as the profit of $759,611.75 realized by International Securities Corporation of America from the exercise of the February 1929 option (supra), a total of $1,681,445.12 (id., Commission's Exhibit No. X3732), were realized by International Securities Corporation of America from the disposition of a security which was ineligible for investment by this company by virtue of the provisions of its debenture indentures. This matter is reviewed infra.

[28] Id., at 26750.

In the transactions recounted above the sums recorded as profits by the various Founders companies through the exercise of options, for which nothing was paid, aggregated $5,166,507.[29] Had these "profits" been specifically revealed by the management and the accountants in the reports published by the Founders companies, stockholders would have been apprised of their extraordinary character, and thus might have reached a more realistic appraisal of their companies' true earning power. They might even have questioned whether these sums were in reality "earnings" at all, and whether they could properly be included in income account, even if segregated and identified. Moreover, those who had purchased these securities and become stockholders of the issuing companies might have learned that a substantial part of the money paid by him in purchase of this stock had been diverted into the income accounts of other companies, of which they were not stockholders. Finally, questions might have been raised on all sides as to what relation there could possibly be between these amazing "profits" and the much vaunted, elaborate research division of the United Founders Group, and their oft-proclaimed international cyclical investment technique. However, lumped under the terse heading, "Interest, Dividends, and Investment Profits," or merely "Investment Profits," there was no visible indication to cause reflection or concern to the stockholders of either the recipient or the issuing companies, or to the investing public.

b. Nondisclosure of Sums Diverted From the Capital Accounts of the Top Founders Companies to the Income Accounts of the Underlying Founders Companies

In addition to the items totaling $5,166,507 detailed above, other sums aggregating $3,007,375.63 were obtained by the underlying Founders companies during the same period in connection with the distribution of the securities of the top Founders companies and were similarly treated as "investment profits." The manner in which these "profits" were realized differed from the transactions described above in only one important detail. Instead of the underlying companies receiving options to purchase stock of the two top companies, in the transactions now to be described the underlying companies actually purchased new issues of stock of the top Founders companies. After holding these shares for a brief period, the underlying companies resold them to the public at steep mark-ups, which yielded these underlying companies large amounts in excess of the prices previously paid to the issuing company. These excess amounts, instead of going to the issuing companies as capital, were retained by the affiliates, and placed in their income accounts.

This oblique course became, in fact, one of the usual modes of distribution of securities practiced by all the companies of the Founders Group. Instead of distributing the new security issues to the public directly, through an independent underwriting or distributing house on a fixed spread or commission basis as was cus-

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[29] Id., Commission's Exhibits Nos. X3847, X3859, and X3861.

tomary for closed-end management investment companies,[30] the Founders companies parceled their new issues among the other members of the Founders Group at prices which experience repeatedly proved were well below those obtainable in the open market. The purchasing companies then distributed these securities to the public through Founders General Corporation, realizing speedy and large "profits" on such sales. Thus, in lieu of the normal primary distribution of these securities by the issuing corporation to the public at a cost probably not greater than 5½%,[31] there were interposed secondary distributors which realized "profits" frequently exceeding 100% [32] (and in some instances exceeding 500% [33]) without performance of any useful function. Manifestly, however, these amazing "profits" garnered by the recipient companies were wholly at the expense of the paid-in capital accounts of the issuing companies; for, instead of the issuing company receiving as paid-in capital the entire proceeds of its security issue, less the usual underwriting fee, it received only a portion of these proceeds. Its affiliated companies, as secondary distributors, received the balance of the capital contribution, which were entered by these affiliates in their "investment profits" accounts, thereby effectively "window-dressing" their earnings statements. The stockholders of the companies of the Founders system, and the investors contemplating the purchase of stock of these companies, had no means of ascertaining from the published reports the source and true character of these "profits," since they were "lumped" in the income statements of the respective companies under the heading "investment profits" without segregation or explanation of any kind.

This system of "manufactured earnings" [34] obviously worked a threefold deception; as to the existing stockholders of the issuing company, because, without their knowledge, their company was deprived repeatedly of substantial portions of its rightful paid-in capital; as to the existing stockholders of the recipient companies, because these large profits, of whose extraordinary and nonrecurrent character stockholders were kept in ignorance, inevitably caused them to exaggerate the reasonably prospective future earning power of their companies; as to the investment public which was induced to purchase the stock of either the issuing or the recipient companies, because they purchased at inflated prices on which the companies could not, over a period of time, pay a reasonable return. Details of these transactions are considered at this point.

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[30] Underwriters were employed in the offering of issues representing 97% of the total gross proceeds ($2,242,000,000) of all public offerings of investment company securities during the period 1927–1935. This ratio generally prevailed in every year for the 1927–1935 period and also for every type of security. (Pt. Two [House Doc. No. 70, 76th Cong.] Ch. III, p. 201 and Table 65.) The average commission or spread paid to underwriters equaled 5.5% of the public offering price and 5.8% of the net proceeds to the companies. (Ibid. and Table 67.)

[31] See note 30, supra. In view of the prestige of the Founders companies with the investing public, there is no reason to assume that Founders would have had to pay underwriting fees greater than the average; in fact, the contrary seems probable.

[32] See supra, p. 2252.

[33] See infra.

[34] For other examples of the use of this term see Graham and Dodd, *Security Analysis* (1934), Ch. XXXII.

It was previously related that United Founders Corporation authorized issues of its common stock in February and July 1929, and that in connection with these issues gratuitous options were granted to underlying Founders companies, which netted these companies profits of $5,166,507. From these same stock issues, other of the Founders companies also were enabled to realize substantial "profits" through a somewhat different device. Instead of receiving options of the kind described above these companies were accorded allotments of the new stock at "inside" prices, which were generally far below the prices for which the stock could be sold on the market.[35]

One of the beneficiaries of this device was Investment Trust Associates, a company acquired by the Founders Group in October 1928. As has already been stated, Investment Trust Associates was granted an option on 20,000 shares of United Founders Corporation stock in June 1929, on which it realized profits of $230,460. Prior to this transaction, at the time of the original issue of common stock by United Founders Corporation in February 1929, Investment Trust Associates was allotted, and actually purchased, 61,000 shares at the "inside" price of $10.50 a share.[36] Of this block of stock, Investment Trust Associates transferred 25,000 shares to an "investment account,"[37] while 36,000 shares remained in a "trading account."[38] But sales in February 1929, and in the first nine days of March 1929, aggregating 103,744 shares, were posted to this "trading account." The trading account, therefore, showed an oversold or "short" position of 67,744 shares, which Investment Trust Associates covered by purchasing from United Founders Corporation three lots of its newly issued common shares at a price of $25.60 a share.[39]

The explanation advanced by the officers of the Founders Group concerning this transaction was, in effect, that when Investment Trust Associates commenced to sell its United Founders Corporation stock it encountered an insistent demand. Rather than turn away these purchasers, Investment Trust Associates continued to sell United Founders Corporation stock, although neither the issuing corporation nor its affiliated companies had the stock to deliver. All sales in excess of the 36,000 shares in its trading account were treated as having been made on behalf of United Founders Corporation, which, on March 9, 1929, authorized issuance of additional shares of stock at a minimum of $25 a share, United Founders Corporation to receive the actual sales price to the public less one point.[40] Of

[35] Frequently, as in the instances set forth in this section, the entire issue was divided among the "insiders," permitting them to release the stock to the public in such quantities as to keep the supply below the demand, thus giving impetus to the prices bid for the stock.

[36] Op, cit. supra, note 5, Commission's Exhibit No. X3862.

[37] Id., Commission's Exhibit No. X3867.

[38] Id., Commission's Exhibit No. X3866.

[39] These purchases were made as follows (id., Commission's Exhibit No. X3866):

March 13, 1929	40,000
March 15, 1929	25,000
March 22, 1929	2,744
Total shares	67,744

[40] Id., at 24669.

this newly issued stock, Investment Trust Associates purchased from United Founders Corporation 67,744 shares to cover its short position, paying $25.60 a share, which was $1 a share less than the price at which it sold the shares to the public.

The "trading account" established by Investment Trust Associates indicated a final profit of $583,451.60, of which $67,744 (being $1 a share) represented the commission on the oversold position, and the balance of $515,707.60 represented profit on the original allotment of 36,000 shares acquired at $10.50 a share and sold at prices ranging from $24.03 to $26.80 a share, an immediate mark-up on cost ranging from 128% to 155%.[41]

The balance of 25,000 shares of United Founders Corporation stock remaining from Investment Trust Associates' orginal allotment of 61,000 shares was disposed of by Investment Trust Associates to the public on August 10, 1929, at an average price of $63 a share, or $52.50 a share above cost, for a total profit of $1,311,230, or 500% above cost.[42]

Another of the Founders companies which was permitted to benefit greatly from the distribution of United Founders Corporation's stock through the medium of allotments at "inside" prices, was Founders General Corporation. At the time of the original issue of United Founders Corporation's common stock in February, Founders General Corporation was allowed to purchase 108,063 shares for its own account at the "inside" price of $10.50 a share,[43] and it disposed of

[41] All purchases and sales were executed for Investment Trust Associates by Founders General Corporation, which sold the shares to dealers and to the public as follows (id., Commission's Exhibit No. X3866):

Sales			Total	
Date, 1929	Shares	Approximate average price		
February	30,669	$24.03	$737,102.75	
March 1-9	73,075	26.80	1,958,595.25	
Total	103,744	25.98		$2,695,698.00
Cost of shares sold:				
February	36,000	10.50	378,000.00	
March 13-22	67,744	25.60	1,734,246.40	
Total	103,744	20.36		2,112,246.40
Realized profits	103,744	5.62		583,451.60

[42] Id., Commission's Exhibit No. X3867.

[43] Id., Commission's Exhibits Nos. X3668 and X3671.

these 108,063 shares forthwith to dealers and to the public at prices which yielded profits aggregating $1,180,438.03.[44]

The various "profits" realized in 1929 by the underlying Founders companies solely from the distribution of United Founders Corporation common stock in the type of transactions previously described aggregated more than $7,500,000,[45] of which approximately $4,500,000 was obtained through the medium of options and approximately $3,000,000 through allotments at "inside" prices.

There were, as has been stated, two distributions of United Founders Corporation stock, one in February 1929, and the other in July 1929. In connection with the February issue, 349,063 shares of

[44] The prices at which Founders General Corporation sold these shares represented mark-ups of 90% to 165% above the original cost to it, as indicated on the following schedule (id., Commission's Exhibit No. X3868):

Founders General Corporation, schedule of certain sales for its own account of common shares of United Founders Corporation

Period of sales 1929	Number of common shares of United Founders Corporation sold	Average sale price	Total sales	Total cost at $10.50 a share	Net profit	Percent of profits upon cost
February	55,395	$20.497	$1,135,455.00	$581,647.50	$553,807.50	95
February	505	20.009	10,115.00	5,302.50	4,812.50	90
February	51,063	22.303	[a] 1,138,858.09	536,161.50	602,696.59	112
March	1,100	27.883	[a] 30,671.44	11,550.00	19,121.44	165
	108,063	21.424	2,315,099.53	1,134,661.50	1,180,438.03	104

[a] Upon first-in, first-out basis, although average price basis was utilized on books. These sales were included in lots of larger size.

[45] These profits are recapitulated and summarized in the following table (id., Commission's Exhibit No. X3869):

Number of shares	Profits Realized from Distribution of Common Stock of United Founders Corporation Sold for account of—	Realized profits
	International Securities Corporation of America	$1,681,445.12
	Second International Securities Corporation	951,305.00
	United States & British International Company, Ltd	793,465.00
	American & General Securities Corporation	789,257.00
380,000	Total	[a] 4,215,472.12
108,063	Founders General Corporation	[b] 1,180,438.03
	Total—American Founders Corporation Group of Companies	5,395,910.15
5,000	Founders Associates	[c] 57,615.00
20,000	Investment Trust Associates	[c] 230,460.00
36,000	Investment Trust Associates	[d] 515,707.60
549,063	Sub-total	6,199,692.75
25,000	Investment Trust Associates	[e] 1,311,230.00
569,063	Total profits from distribution	7,510,922.75

[a] Public Examination, American General Corporation, et al., Commission's Exhibits Nos. X3859 and X3861. These profits were realized through the exercise of options, in the manner previously described.

[b] Id., Commission's Exhibit No. X3868.

[c] Id., Commission's Exhibit No. X3861. This profit was realized through the exercise of an option, as previously described.

[d] Id., Commission's Exhibit No. X3866.

[e] The first four items of this recapitulation may be observed also in Commission's Exhibit No. X3732. With respect to Investment Trust Associates, the three items of realized profits aggregate $2,057,397.60. When this is added to the sum of $67,744, realized as a profit on the sale of 67,744 shares (supra), the total is $2,125,141.60 as seen in Commission's Exhibit No. X3732.

United Founders Corporation stock were distributed in the fashion described above by the underlying Founders companies at a profit of $3,895,099.38.[46] The price at which these shares were sold to the public represented a spread of approximately $11 a share on stock costing $10.50. That this spread constituted, in large measure, an outright diversion from the capital account of United Founders Corporation is indicated by the fact that, at about the same time, commencing in March 1929, and continuing to July 1929, United Founders Corporation sold directly to the public, through the agency of Founders General Corporation, 2,400,000 shares of its common stock, and received the full price paid by the public less a marketing fee of from $1 to $2 a share.[47] For these shares United Founders Corporation received prices ranging from $27.21 to $51.01 a share,[48] as compared with the $10.50 price paid to it during the very same period of time by the various Founders companies on the purchases recounted above.

In connection with the July issue of United Founders Corporation stock, 195,000 shares were allotted to the underlying Founders companies at $41 a share.[49] These shares were immediately resold by the Founders companies to the public at an advance of about $13, or $54.063 a share.[50] In comparison with this $13 spread, it is to be noted that during this same month United Founders Corporation was, as has been recounted above, selling its shares to the public at a spread of only $1 to $2.

From the details set forth above, it is apparent that the $7,510,000 which went to swell the profit accounts of the various underlying Founders companies for the year 1929 represented, not profits from "skillful international cyclical trading," but a bald diversion from the paid-in capital account of United Founders Corporation. Nevertheless, neither in the financial statement of United Founders Corporation nor of the various Founders companies which shared these "profits" was any indication of these facts afforded the stockholders and the public. W. H. Conkling, a member of the firm of Loomis, Suffern & Fernald, auditors for United Founders Corporation and consulting accountants for the other Founders companies, when ex-

[46] See the following:

	Shares	*Profit realized*
1	205, 000	[a] $2, 198, 953. 75
1	108, 063	[b] 1, 180, 438. 03
1	36, 000	[c] 515, 707. 60
Total	349, 063	3, 895. 099. 38
2	200, 000	[d] 2, 304, 593. 37
	549, 063	6, 199, 692. 75

[a] Public Examination, American General Corporation, et al., Commission's Exhibit No. X3859.
[b] Id., Commission's Exhibit No. X3868.
[c] Id., Commission's Exhibit No. X3866.
[d] Includes profit of $57,615 realized through exercise of option on 5,000 shares. (Id., Commission's Exhibit No. X3861.)

[47] Op. cit. supra, note 5, Commission's Exhibit No. X3870.

[48] Id., Commission's Exhibit No. X3421, A–4.

[49] Id., Commission's Exhibits Nos. X3861 and X3421, A–4.

[50] Ibid.

amined as to the accountant's responsibility for this situation, testified:[51]

Q. Then your answer, I take it, to practically all four questions, is that accountants don't do anything and that you don't think they can do anything?

A. That would be my answer, yes.

Q. Now, you appreciate the dangers inherent in a situation where X dollars goes into a corporation and the stockholding public pays 2 or 3 X dollars for that when there has been no change in the situation, just the organization of the corporation?

A. Yes.

Q. And that difficulty is that the company has X dollars to work with and the stockholder has paid 2 or 3 X dollars for his shares immediately in a company which has nothing but X dollars. In that situation, there is an almost inevitable disappointment?

A. Yes. Of course the stockholder or the person buying the securities at the offering price presumably under present-day conditions will get a prospectus containing statements and other information with respect to the company, from which he should be able to form some opinion as to whether he considers the price he is offered the securities at is a price he is willing to pay. If the offering price is too high, presumably he would refuse to buy, and if enough persons refuse to buy there won't be a market for the securities at that price. I don't know how else that matter can be controlled.

Q. Take this situation that happened: The inside groups—that is, people affiliated, sponsors, co-sponsors, and what you will—contracted to pay $12.50 per share on one day, and on the next day those shares were selling in the market * * * for twice that figure. Nothing happened to the corporation. They had a commitment to pay in $12.50, but they were snapped up in the market at that figure. Is there anything that would be done under those circumstances by an accountant or would have been done in those days by an accountant, to have disclosed that situation in the final report?

A. I believe there is nothing that would have been done by an accountant in those days to disclose that situation.

c. Nondisclosure of Sums Diverted to Income Accounts of Various Founders Companies on Distribution of the Stock of Investment Trust Associates

In 1928, Investment Trust Associates, previously a personal holding company of Christopher F. Coombs, was taken over by the Founders Group and reorganized as a Founders company. All of its assets were transferred to another company controlled by Mr. Coombs, and the name and charter alone were retained.[52] On November 7, 1928, the board of directors of the reorganized Investment Trust Associates authorized the issuance of 400,000 of its common shares at $10 a share.[53] During this month of November 1928, 340,000 of these

[51] Id., at 26746–8.

[52] Id., at 22096.

[53] Id., Company's Exhibits Nos. 1 and 2.

shares were taken down at the "inside" price of $10 a share [54] by various of the Founders companies.[55]

Within the same month of November 1928, these companies disposed of 70,646 shares at prices ranging from $20 to $39, or a spread of $10 to $29 a share on a $10 stock, for an aggregate profit of $913,780.[56] The balance of 60,000 shares of Investment Trust Associates stock not yet issued was taken down early in 1929 by two Founders companies at the same "inside" price of $10 a share.[57] Of these 60,000 shares, 10,000 shares were taken down by United States & British International Company, Ltd., in February 1929, and 50,000 shares were taken down in January 1929, by American & General Securities Corporation.[58] In the period from January to April 1929, 10,800 shares of this lot of 50,000 shares were disposed of to the public by American & General Securities Corporation at an aggregate profit of $442,120.25 at prices carrying a distribution load exceeding 400%.[59]

[54] Ibid.

[55] These shares were taken down as follows (id., at 24154–6):

American Founders Corporation	95, 000
International Securities Corporation of America	140, 000
Second International Securities Corporation	65, 000
United States & British International Company, Ltd	40, 000
Total shares taken down	340, 000

[56] The following table gives the break-down of this aggregate profit (id., Commission's Exhibits Nos. X3848 and X3732):

	American Founders Corporation	International Securities Corpora- of America	Second International Securities Corporation	United States & British International Company, Ltd.	Totals
Number of common shares of Investment Trust Associates sold in November 1928	2, 800	42, 846	15, 000	10, 000	70, 646
Total cost of acquisition in November ber 1928 at $10 per share	$28, 000	$428, 460	$150, 000	$100, 000	$706, 460
Sales proceeds	$56, 000	$964, 240	$400, 000	$200, 000	$1, 620, 240
Range of prices	$20	$20 to $39	$20 to $30	$20	$20 to $39
Average sales price	$20	$22. 50	$26. 67	$20	$22. 93
Net profits realized	$28, 000	$535, 780	$250, 000	$100, 000	$913. 780
Percent of profit upon cost	100	125	166	100	129

[57] Id., at 24154–6.

[58] Ibid. and id., Commission's Exhibit No. X3781.

[59] The following table gives the break-down of this distribution (id., Commission's Exhibit No. X3849):

Sales of Investment Trust Associates stock by American & General Securities Corporation

Month of sales (1929)	Number of shares	Average sales price	Sales proceeds
January	6, 710	$51. 21	$343, 631. 50
February	1, 000	47. 80	47, 800. 00
March	3, 020	51. 36	155, 118. 75
April	70	51. 00	3, 570. 00
Total	10, 800	50. 94	550, 120. 25
Total cost at $10 a share	10, 800		108, 000. 00
Net profit			442, 120. 25

These profits of $442,120.25, together with the profits of $913,780 previously detailed as having been realized by the Founders companies from the sale of Investment Trust Associates stock, totaling $1,355,900.25, were profits gained through sales by these companies to the public.[60] In addition, there was a purely intercompany profit of $4,172,000 which was realized August 13, 1929, on a sale by the same underlying Founders companies to United Founders Corporation, of 119,200 shares of Investment Trust Associates common stock. These shares were sold at $45 a share,[61] the underlying companies having acquired them, as has been stated, at the original "inside" price of $10 a share.[62] In another sale, on May 14, 1930, by the same Founders companies to United Founders Corporation of 146,154 common shares of Investment Trust Associates at $31 a share, a profit was realized of $1,698,187.[63] These two sales of Investment Trust Associates common stock by the underlying Founders companies to the top Founders company are discussed in detail in the chapter relating to profits realized by companies in the group from sales to one another.[64]

d. Nondisclosure of Sums Diverted to Income Accounts of Founders Companies on Distribution of Stock of American & General Securities Corporation

On a very much smaller scale were the "profits," aggregating $99,240, realized by Second International Securities Corporation and United States & British International Company, Ltd., from the sale by them of Class A shares of American & General Securities Corporation immediately upon receipt of these shares in November 1928, the same month in which they were issued.

American & General Securities Corporation was formed on October 31, 1928.[65] Under date of November 1, 1928, American Founders Corporation obligated itself to take down before December 31, 1928, 100,000 shares of the Class A common stock of American & General Securities Corporation at $20 a share.[66] Of this block, 50,000 shares were distributed as follows: 14,450 shares were turned over November 12, 1928 by American Founders Corporation to a preferred or selected list, consisting in the main of officers, directors and executive employees of the Founders Group, at $20 per share; 650 shares were sold to the public at $30 and $31 a share;[67] and on November 22, 1928, American Founders Corporation distributed among three Founders companies a block of 34,900 shares at the original issue price of $20 a share, as follows:[68]

[60] Id., Commission's Exhibit No. X3732B.
[61] Id., Commission's Exhibit No. X3850.
[62] Id., at 24154–6.
[63] Id., Commission's Exhibit No. X3857.
[64] See infra, p. 2276.
[65] Op. cit. supra, note 5, Commission's Exhibit No. X3410.
[66] Id., Commission's Exhibit No. X3410 (D–2).
[67] Id., Commission's Exhibit No. X4282.
[68] Ibid.

	Shares
Investment Trust Associates	25,000
United States & British International Company, Ltd	5,000
Second International Securities Corporation	4,900

The remaining 50,000 shares were retained by American Founders Corporation for its own account.[69] The 25,000 shares received by Investment Trust Associates from American Founders Corporation on November 12, 1928, at $20 a share were sold on August 14, 1929, to United Founders Corporation at $30 a share, at an aggregate profit of $250,000.[70] Thereafter, in April 1930, this block of stock was in turn sold by United Founders Corporation to American Founders Corporation.[71] These transactions are reviewed in a following section devoted to profits derived from intra-group sales.[72] The 9,900 shares received, as indicated above, on November 12, 1928, by Second International Securities Corporation and United States & British International Company, Ltd., at $20 a share were sold by them at once at an average price of approximately $30 a share, for an aggregate profit of $99,240.[73]

In addition to the Class A common stock, American & General Securities Corporation, immediately after its organization in October 1928, also issued a total of 500,000 shares of Class B common stock, all of which were taken down in November 1928, by American Founders Corporation at $2 a share.[74] Of this block of 500,000 shares, American Founders Corporation redistributed 162,500 shares at original cost price of $2 a share as follows:[75]

	Shares
To Investment Trust Associates	100,000
To Founders General Corporation	25,000
To Messrs. Coombs, Erwin, and Seagrave[76]	37,500
	162,500

From the remaining block of 337,500 shares, American Founders Corporation immediately distributed 17,300 shares at a price of $2 a share among a selected or preferred list, consisting in the main of officers, directors, and executive employees, and it sold 200 shares at $5 and 19,485 shares at an average price of $5.42 to the public during the month of November 1928. The profit realized on these transactions amounted to $67,160.[77]

The block of 100,000 Class B shares of American & General Securities Corporation, which was transferred in November 1928 by American Founders Corporation to Investment Trust Associates at

[69] Id., Commission's Exhibits Nos. X3410 (D–2) and X4283.

[70] Id., Commission's Exhibit No. X3853.

[71] Id., Commission's Exhibit No. X4276.

[72] See infra, p. 2275.

[73] Op. cit. supra, note 5, Commission's Exhibits Nos. X3879 and X3732. This profit was divided: United States & British International Company, Ltd., $50,240; Second International Securities Corporation, $49,000.

[74] Id., Commission's Exhibits Nos. X3410 (D–3) and X3411 (A–3).

[75] Id., Commission's Exhibit No. X4284.

[76] These men were officers of the Founders system who comprised the inner management group.

[77] Op. cit. supra, note 5, Commission's Exhibit No. 3880.

the "inside" price of $2 a share, was sold by Investment Trust Associates on August 14, 1929, to United Founders Corporation at $14 a share, for a total profit of $1,200,000.[78] Thereafter, United Founders Corporation in turn transferred the same block of shares to American Founders Corporation. These transactions are discussed in detail hereafter in the section on profits derived from sales by companies within the group to other companies within the group.[79]

As has been indicated above, 25,000 shares of American & General Securities Corporation Class B stock was transferred by American Founders Corporation to its wholly owned subsidiary, Founders General Corporation, at $2 a share. This stock was not taken down at once by Founders General Corporation but was drawn upon from time to time during 1929 and 1930, as the shares were needed. Founders General Corporation was engaged during 1929 in supporting the market in the shares of American & General Securities Corporation, in the same fashion that it supported the stocks of all the Founders companies.[80] In the course of its trading activities, it sometimes found it had oversold Class B stock of American & General Securities Corporation. These oversold positions Founders General Corporation was able to cover by drawing upon the 25,000 shares allotted to it by American Founders Corporation.[81] During the 1929 fiscal period, 13,161 shares of the 25,000-share lot were taken down by Founders General Corporation at $2 a share to straighten out its trading position.[82] The remaining 11,839 shares were taken down in January 1930. As a result of its ability to fall back upon these shares at $2 a share whenever it was oversold, Founders General Corporation was enabled to realize from its trading activities in American & General Securities Corporation Class B stock during 1929,[83] profits of $198,617.90.[84]

e. Nondisclosure of Sums Diverted to Income Accounts of Founders Companies on Distribution of Securities of The Public Utility Holding Corporation of America

The practice of deflecting large sums from the capital accounts of newly formed companies of the Founders Group or affiliated companies in order to record them as profits in the accounts of other Founders companies, was brought to its fullest development in the instance of The Public Utility Holding Corporation of America. In the distribution of the shares of this company, various Founders companies, following the familiar pattern, realized profits of $8,094,189.64.[85]

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[78] Id., Commission's Exhibit No. X3853.

[79] See infra, p. 2275.

[80] For a discussion of the market-maintenance activities of Founders General Corporation, see Sec. II, supra.

[81] Op. cit. supra, note 5, Commission's Exhibit No. X4285.

[82] Ibid.

[83] In 1929 sales by Founders General Corporation of American & General Securities Corporation Class B stock totaled 43,575 shares. During the same period reacquisitions by Founders General Corporation of this same class of stock totaled 41,478 shares. (Id., Commission's Exhibit No. X4285.)

[84] Id., Commission's Exhibits Nos. X4285 and X3732.

[85] Id., Commission's Exhibit No. X3732.

The Public Utility Holding Corporation of America was incorporated on September 5, 1929.[86] Shortly after its formation, the corporation authorized the issuance of its common shares, with warrants, at a basic price of $12.50 a unit.[87] One lot, aggregating 1,350,000 shares, was issued at a fixed price of $12.50 to the companies in the Founders Group.[88]

Simultaneously with the issue of these 1,350,000 shares, The Public Utility Holding Corporation of America arranged with Founders General Corporation for the latter to employ "its best efforts" to find purchasers for an additional block of 500,000 shares of The Public Utility Holding Corporation's stock. Founders General Corporation agreed to pay over to The Public Utility Holding Corporation the full amount realized from the sale of this stock less only a selling commission of $1 a share, the minimum price to be $12.50 a share, after deducting the commission.[89] Under this arrangement, The Public Utility Holding Corporation received for these 500,000 shares the sum of $12,237,830, or an average price, after commissions, of $24.48 a share.[90] This sale brought into the treasury of The Public Utility Holding Corporation approximately $6,000,000 more than would have been realized if the stock had been issued to Founders companies for $12.50 a share as the block of 1,350,000 shares described above. Had these 1,350,000 shares been disposed of by The Public Utility Holding Corporation in the market at the average price of approximately $24.48 obtained for the 500,000 share block, they would have brought $33,048,000, a sum $16,173,000 greater than the price of $16,875,000 obtained by The Public Utility Holding Corporation from the sale to the Founders companies.

The Founders companies did not, however, immediately resell the entire 1,350,000 shares but proceeded to dispose initially of 419,564 shares. These 419,564 shares were sold for the Founders companies by Founders General Corporation at prices ranging from $25.61 to $29.90

[86] Id., Commission's Exhibit No. X3423.

[87] Id., Commission's Exhibit No. X3423 (3b).

[88] The distribution was as follows (id., Commission's Exhibits Nos. X3423 (3b) and X3424–D):

	Number of shares	Net proceeds at $12.50 a share
United Founders Corporation	633, 333	$7, 916, 662. 50
American Founders Corporation	276, 667	3, 458, 337. 50
Founders General Corporation:		
For account of itself	15, 500	193, 750. 00
For account of others, including 24,500 for account of American Founders Corporation	160, 500	2, 006, 250. 00
American & General Securities Corporation	32, 000	400, 000. 00
Founders Associates	40, 000	500, 000. 00
International Securities Corporation of America	80, 000	1, 000, 000. 00
Investment Trust Associates	40, 000	500, 000. 00
Second International Securities Corporation	40, 000	500, 000. 00
U. S. & British International Co., Ltd	32, 000	400, 000. 00
	1, 350, 000	16, 875, 000. 00

[89] Id., Commission's Exhibit No. X3423 (3b and 3c).

[90] Id., Commission's Exhibit No. X3875.

a share, for the aggregate sum of $12,518,829.25.[91] These shares were sold by Founders General Corporation at the very same time and on the same market that Founders General Corporation was engaged in selling the 500,000 shares for The Public Utility Holding Corporation,

[91] These 419,564 shares (with warrants) were disposed of in four lots.

Lot No. 1, aggregating 248,000 shares, was sold by Founders General Corporation for the accounts of the Founders companies in September 1929, the very month they were issued at $12.50 a share, for $29.55 a share. Founders General Corporation received a commission of $1 a share, reducing the remittance to $28.55 a share. In certain cases transfer taxes were paid from this account, reducing the remittance to $28.51 a share.

Lot No. 2 was a block of 24,500 shares sold by Founders General Corporation for the account of American Founders Corporation in September 1929, at $25.608 a share.

Lot No. 3 was a sale in September 1929 by United Founders Corporation to United States Electric Power Corporation, a newly formed affiliate, of 80,000 shares at a gross price of $30 a share, which, after expenses, netted $29.90 a share. Notwithstanding the relationship between the two companies, United Founders Corporation made a profit of 139% in this transaction on stock acquired only a few days earlier.

Lot No. 4 comprised 67,064 shares purchased by Founders General Corporation from International Securities Corporation of American & General Securities Corporation at $26.73 a share to assist in covering Founders General Corporation's oversold position in this stock in November 1929.

The above transactions are itemized in the following table (id., Commission's Exhibit No. X3876):

Profits realized from sales of common shares, with warrants, of the Public Utility Holding Corporation in September and November 1929

Lot Number	Period of sales 1929	Sold for the Account of—	Number of P. U. H. C. Common Shares (with warrants) sold	Sales Proceeds (after deduction for commission at $1 (*) plus stamp taxes at 4¢ per share (**))	
				Per Share	Total
1.	September	American Founders Corporation	80,000	$28.5146	$2,281,166.55**
2.	September	American Founders Corporation	24,500	25.6081	627,400.00
			104,500		2,908,566.55
1.	September	Int'l Sec. Corp. of America	16,000	28.5546	456,189.34*
4.	November	Int'l Sec. Corp. of America	64,000	26.731	1,710,771.20
			80,000		2,166,960.54
1.	September	Second Int'l Sec. Corp	8,000	28.5546	228,451.32*
1.	September	U. S. & British Int'l Co., Ltd	8,000	28.5164	228,131.32**
1.	September	Amer. & Gen'l Sec. Corp	8,000	28.5164	228,131.32**
4.	November	Amer. & Gen'l Sec. Corp	3,064	26.732	81,907.05
			11,064		310,038.37
	Totals	American Founders Group	211,564		5,842,148.10
1.	September	United Founders Corp	120,000	28.5546	3,426,549.83*
3.	September	United Founders Corp	80,000	29.90	2,392,000.00
			200,000		5,818,549.83
1.	September	Investment Trust Associates	8,000	28.5164	228,131.32**
		GRAND TOTALS	419,564		$11,888,829.25

(Footnote 91 continued on p. 2271)

as recounted above.[92] Instead, however, of remitting the full proceeds of this sale, less $1 as selling commission, to The Public Utility Holding Corporation, as it was doing with the block of 500,000 shares, Founders General Corporation remitted these proceeds to the various Founders companies. The Founders companies thereby on this block of 419,564 shares of The Public Utility Holding Corporation stock obtained $7,274,279 which they entered in their "investment profits" accounts;[93] and in addition they retained in their portfolios the balance of 930,436 shares at a cost of $12.50 a share while the current market price ranged from $24 to $29.90 a share.

It is apparent that the "profits" of $7,274,279 garnered by the various Founders companies on the resale of this block of 419,564 shares to the public was actually a deflection from the capital account of The Public Utility Holding Corporation. Purchasers of these 419,564 shares of stock who thereby became stockholders in The Public Utility Holding Corporation paid for their shares $12,518,829,[94] but, unknown to them, only the sum of $5,244,500 found its way into the treasury of their corporation. Thus, The Public Utility Holding Corporation was deprived at the outset of more than 58% of the capital contributed by its stockholders in the purchase of these shares, and the corporation was obviously thereby greatly handicapped in attempting to earn for these stockholders a fair return on their investment.

Lot Number	Period of sales 1929	Sold for the Account of—	Total cost of shares (with warrants) purchased in September 1929 at $12.50 each	Amount of realized profits	Percent of profits upon cost
1.	September	American Founders Corporation	$1,000,000	$1,281,166.55	128
2.	September	American Founders Corporation	306,250	321,150.00	105
			1,306,250	1,602,316.55	123
1.	September	Int'l Sec. Corp. of America	200,000	256,189.34	128
4.	November	Int'l Sec. Corp. of America	800,000	910,771.20	114
			1,000,000	1,166,960.54	117
1.	September	Second Int'l Sec. Corp	100,000	128,451.32	128
1.	September	U. S. & British Int'l Co., Ltd	100,000	128,131.32	128
1.	September	Amer. & Gen'l Sec. Corp	100,000	128,131.32	128
4.	November	Amer. & Gen'l Sec. Corp	38,300	43,607.05	114
			138,300	171,738.37	124
	Totals	American Founders Group	2,644,550	3,197,598.10	121
1.	September	United Founders Corp	1,500,000	1,926,549.83	128
3.	September	United Founders Corp	1,000,000	1,392,000.00	139
			2,500,000	3,318,549.83	133
1.	September	Investment Trust Associates	100,000	128,131.32	128
		GRAND TOTALS	5,244,550	6,644,279.25	127

NOTE: After the close of the fiscal year ended November 30, 1929, in December 1929, correction was made of sales ticket dated September 1929, to Washburn Frost & Co., for 25,000 shares at $28, entered at $70,000, instead of $700,000, an error of $630,000. This amount of $630,000 was retained by Founders General Corp., characterized as a realized profit, and entered as such in its realized profits account for 1930. Above total of realized profits of $6,644,279.25 is thereby increased to $7,274,279.25.

[92] Id., Commission's Exhibit No. X3876, and see supra p. 2270.

[93] Id., Commissions Exhibit No. X3876. This amount includes $63,000 retained, in error, by Founders General Corporation. See note appended to table in note 91, supra.

[94] Ibid. This sum represents the net proceeds of the sales. Purchasers paid additional sums as commissions, taxes, etc., the exact amount of which is not ascertainable.

Frederick S. Burroughs, who became president of The Public Utility Holding Corporation on its formation, having been a partner in Harris, Forbes & Co.,[95] which participated with the Founders Group in the formation of the corporation, testified as follows with respect to the issue of stock to the Founders companies at $12.50 a share: [96]

Q. You had stated that it was practically inevitable when stock was brought out by an investment trust that it would immediately jump away in advance of passing asset values.

A. That is correct.

Q. And that was fairly common knowledge?

A. Very common knowledge.

Q. Why wasn't it a simple matter then to sell all of the securities to the public, through an agent who would get a fixed fee and have all the money that came from the sale of stock go into the corporation? * * * Why wasn't the technique prescribed in the Founders General selling followed in the case of all the shares? * * * Why wouldn't that have been the thing to do in the case of the Founders shares?

A. I think it would have been.

By Mr. Riggs [counsel to the Founders companies]:

Q. That could not have been done and comply with the Blue-Sky laws of the various states?

A. I don't know about that. Mr. Stern is asking me about the transaction as it was handled * * * I don't think any of that original $12.50 stock should have been turned right out and sold and a profit made by the organizers of the enterprise.

In addition to the 419,564 shares of The Public Utility Holding Corporation stock disposed of in the latter part of 1929, as recounted above, 100,000 shares were sold by Founders General Corporation in March 1930, for the account of the various Founders companies at $18 a share.[97] On this block of stock the respective Founders companies entered in their profit accounts sums aggregating $518,911.15.[98]

Further "profits" in the sum of $302,941.32 were realized in 1930 by two of the Founders companies from the sale of stock warrants of The Public Utility Holding Corporation. Of this sum, Founders General Corporation received $1,157,50 and United Founders Corporation received $301,783.82.[99] These warrants had been acquired by United Founders Corporation without cost in connection with its allotment in September 1929, of The Public Utility Holding Corporation stock at $12.50 a share.[100]

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[95] Public Examination, American General Corporation, et al., at 25389–90.

[96] Id., at 25442–3.

[97] This stock was sold to Harris Trust and Savings Bank of Chicago. (Id., Commission's Exhibits Nos. X4282 and X3878.) At about the same time The Public Utility Holding Corporation likewise arranged, through Founders General Corporation, a sale to the same purchaser of 134,372 shares of its stock, receiving prices of $20 and $22 a share (id., Commission's Exhibits Nos. X3423 [3–e] and X3423a [19a]), as compared with the price of $12.50 a share that it had received from the various Founders companies which were also selling The Public Utility Holding Corporation stock to the same purchaser at this time.

[98] Id., Commission's Exhibit No. X3878.

[99] Id., Commission's Exhibit No. X3732. In April 1930, United Founders Corporation disposed of 47,133½ warrants at approximately $6 each, or $281,858.32, and in October 1930, it disposed of 11,300 warrants at $1.75 to $2 each, or a total of $19,925.50. Founders General Corporation realized its profit of $1,157.50 through trading in these warrants.

[100] Id., Commission's Exhibit No. X3423.

After making allowance for all proper deductions,[101] the amounts placed in their profit accounts by the Founders Group in connection with the distribution of the shares and warrants of The Public Utility Holding Corporation totaled $8,094,189.64.[102]

f. Recapitulation of Sums Diverted from Capital Accounts of Founders Companies and Entered in Income Accounts of Other Founders Companies

The sums entered by the various Founders companies in their profit accounts from the transactions detailed above which occurred for the most part in 1928 and 1929, totaled $23,289,540. These sums were obtained, as has been seen, in the distribution of the shares of American Founders Corporation, Investment Trust Associates, American & General Securities Corporation, United Founders Corporation, and The Public Utility Holding Corporation of America.[103]

The transactions described illustrate several of the divers categories of intercompany dealings which characterized the Founders system. There were dealings by the underlying companies in the securities of the two top companies—American Founders Corporation and United Founders Corporation; dealings by the top companies, American Founders Corporation and United Founders Corporation, in securities of the underlying and affiliated companies; and dealings by the under-

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[101] Deduction has been made of the sum of $1,942.08, representing the net loss of Founders General Corporation in the distribution of this stock in 1929 and 1930 which was offset by its trading profit in 1930.

[102] This total is computed as follows:

Profit from distribution of 419,564 shares in 1929	$7,274,279.25
Profit from sale of 100,000 shares at $18 in 1930	518,911.15
Profit from sale of warrants	302,941.32
Total	8,096,131.72
Deduct trading loss of Founders General Corporation	1,942.08
Net profit realized	8,094,189.64

[103] Following is an itemization of these sums:

"Profits" recorded, as described in subsection a, supra, in 1928 by International Securities Corporation of America, Second International Securities Corporation, and United States & British International Company, Ltd	[a] $662,960.51
"Profits" recorded as described in subsection c, supra, in 1928 and 1929, by the three companies named above and by American Founders Corporation	[a] 1,355,900.25
"Profits" recorded in August 1929, by the sale of Investment Trust Associates stock to United Founders Corporation, mentioned in subsection c, supra, and described in detail hereafter	4,172,000.00
"Profits" recorded, as described in subsection d, supra	[a] 99,240.00
"Profits" recorded on sale, in August 1929, of American & General Securities Corporation Class B stock by Investment Trust Associates to United Founders Corporation, as described in subsection d, supra, and discussed in detail, infra	1,200,000.00
"Profits" recorded on Class A stock of American & General Securities Corporation, as described in subsection d, supra	250,000.00
"Profits" recorded, as described in subsection b, supra, in February and July 1929 by the various Founders companies	[a] 6,142,077.75
"Profits" recorded by Investment Trust Associates on sale of United Founders Corporation stock in August 1929, as described in subsection b, supra	1,311,230.00
"Profits" recorded by various Founders companies on distribution in 1929 of stock of The Public Utility Holding Corporation of America as described in subsection e, supra	[a] 7,274,279.25
"Profit" recorded from sale in March 1930 of 100,000 shares of The Public Utility Holding Corporation common stock	518,911.00
"Profit" recorded from sale of stock warrants of The Public Utility Holding Corporation, as described in subsection e, supra	302,941.32
Total "profits" recorded	23,289,540.08

[a] "Profits realized almost immediately after issuance of specified securities.

lying companies in the securities of other underlying companies and of affiliated companies. Other categories of securities dealings will be considered in later sections.

In this welter of intercompany dealings by the companies of the Founders Group and their affiliates, not only did the Founders management possess great latitude in determining which companies should profit, but also in determining the time when these "profits" should be taken in order to show up to greatest advantage in the published income statements of the various recipient companies—in other words to engage in "window dressing" of these reports.[104] On this subject, Louis H. Seagrave, president of American Founders Corporation, stated:[105]

> I am not going to deny there were times when we were looking over the portfolio of the companies and saw an opportunity to take a profit, but we did not take it, and it was a very customary thing at the year end for the investment department to analyze the position, whether the question was to allow the unrealized appreciation or the right to sell some security, and undoubtedly there were times when we did precisely that.

The sum of $23,289,540 entered by the various Founders companies in their profit accounts in the period 1928 to 1930 by virtue of the transactions described above, represented more than one-half of all the investment profits recorded by the Founders Group for the entire period.[106] Of this fact the stockholders of the Founders companies and the investing public were afforded no indication, for these amounts lay hidden behind the laconic and inscrutable heading, "Profits on sale of investments," in reports prefaced with descriptions of the unique international "investment technique" of the Founders companies, the Founders' superlative research department, and their practice of cyclical investment in depressed and buoyant markets throughout the world.

Nor was any indication given to the stockholders of the various Founders companies issuing the securities or to the investing public which purchased them, that the predominant part of the $23,000,000 "profit" reported by the Founders Group represented diversions from the paid-in capital accounts of the issuing corporations, which would seriously impede these corporations in earning a fair return on the investment actually made by the public.[107]

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[104] For example, it was related in previous sections that in 1928 "profits" were gained by companies of the Founders Group on three of the intercompany securities transactions described above. In each of the three cases, it is significant that the resales were made by the Founders companies and the profits "realized" in the month of November. November was the last month of the 1928 fiscal period, so that the sums obtained from these transactions went to bolster the income statements accompanying the 1928 published reports of the Founders companies. The three groups of profits alluded to totaled $1,675,980. They were:

(1) "profits" of $662,960 realized by the underlying Founders companies on the exercise of options for stock of American Founders Corporation, as described in detail in subsection a, supra;

(2) "profits" of $913,780 realized by Founders companies on distribution of shares of Investment Trust Associates, as described in detail in subsection c, supra;

(3) "profits" of $99,240 realized by Founders companies on disposition of stock of American & General Securities Corporation, as described in detail in subsection d, supra.

[105] Op. cit. supra, note 95, at 24101.

[106] The full amount, as has been stated in Sec. A, was $43,269,733. See also Appendix R, p. 2457.

[107] Of the "profits" itemized in note 103, items totaling $15,534,457 were "realized" almost immediately after issuance of the stock and consequently cannot possibly be deemed to

2. FAILURE TO SEGREGATE AND REVEAL SUMS DERIVED FROM INTERCOMPANY TRANSACTIONS IN THE FOUNDERS GROUP'S SECURITIES AND PLACED IN INCOME ACCOUNTS

The sums exceeding $23,000,000, which in the preceding section were shown to have been diverted into the income accounts of the companies of the Founders Group in connection with the issuance of the capital shares of the various Founders companies and affiliates, do not, by any means, represent the entirety of the "income" recorded by the group from this source.

In the main, the preceding section discussed transactions in which Founders companies received allotments of, or options on, newly issued stock of other Founders companies or affiliates, which they promptly resold to the public at steep mark-ups, thus realizing swift and substantial "profits." In some cases, however, the Founders company receiving the newly issued stock, instead of realizing its profit by selling the stock to the public, sold it instead to another Founders company at a substantial mark-up. Several such transactions were identified in the preceding section and were set apart for further discussion in the present section.[1] In addition, consideration is given in this section to other transactions of a like character: sales by certain Founders companies to other Founders companies of the securities of some third Founders company or of an affiliate. In some instances the securities of one Founders company, having been issued at an "inside" price to another Founders company, were later shifted successively to two or three other Founders companies, each Founders company in turn recording a profit on transferring to its successor. In one such case described hereafter, a block of stock, having made a circuit of several Founders companies, finally returned to the portfolio of the Founders company which had been the initial owner, at a cost approximately 400% higher than that at which it had been carried originally, each Founders company having extracted a "profit" before passing on the stock to the next Founders company.[2] Transactions of a similar nature discussed in the present section resulted in swelling the income accounts of the Founders companies by amounts aggregating $8,479,950.[3]

These sums, like those detailed in the preceding section, were neither segregated in the published financial statements of the Founders companies nor identified in any other manner, but were lumped in the income accounts under the unrevealing heading "In-

have constituted "investments." These items were indisputedly diversions from the capital accounts of the issuing corporations. Other items, totaling $7,452,141, were not disposed of by the purchasing companies for periods of six months or longer and consequently do not afford as clear-cut instances of diversions from capital accounts of the issuing companies, as the figures set forth above. The "profit" of $302,941 from the sale of stock warrants was also realized at a later date.

[1] The transactions described in this section are, it will be noted, for the most part intercompany transactions in the strict technical sense, as distinguished from the broad sense in which the term was employed in the preceding sections.

[2] See infra, p. 2286.

[3] It is to be noted, however, that of this sum $5,622,000 is attributable to the transactions noted in the preceding section and was included in the computations made therein.

vestment Profits."[4] In consequence, together with the sums previously discussed, they served ostensibly to place a seal of authenticity and truth on the management's repeated claims respecting the success of the Founders' "international investment technique." Thereby, the popularity of Founders securities with the investing public was maintained and enhanced, and further sales facilitated.

a. Sums Entered in Profit Accounts by Underlying Founders Companies Through Dealings With United Founders Corporation

As has been stated,[5] in November 1928 a group of Founders companies was allotted 340,000 of the newly issued common stock of Investment Trust Associates at $10 a share, and in January and February 1929 60,000 shares additional were taken down. Approximately 81,500 shares of this stock were sold by the Founders companies to the public through Founders General Corporation during 1928 and the early part of 1929 at "profits" which totaled $1,355,900.[6]

On August 13, 1929, the four Founders companies sold to United Founders Corporation, the top Founders holding company, a block of 119,200 shares of common stock of Investment Trust Associates at $45 a share for a total of $5,364,000.[7] Since this stock had cost the selling Founders companies $10 a share, the "profit" realized in this transaction was $4,172,000, or 350% on cost.[8]

Investment Trust Associates, whose stock United Founders Corporation thus purchased from its affiliates at a price more than four times that which they had paid, was at this same time active in its own behalf in realizing profits through transactions with other Founders companies involving securities of various Founders companies, acquired at "inside" prices. These transactions demonstrate the complex pattern which dealings within the Founders Group sometimes assumed.

The element of timing is particularly important in the transactions which follow. Investment Trust Associates was preparing to issue, and on August 15, 1929, did issue, "rights" to its share-

[4] Public Examination, American General Corporation, et al., Commission's Exhibits Nos. X3401, X3406, X3410, X3408, X3412, X3404, and X3420 (published reports of Founders companies).

[5] See supra, p. 2264.

[6] Ibid.

[7] See supra, p. 2258. This stock was retained in the portfolio of United Founders Corporation until 1930 when it was transferred to American Founders Corporation at cost.

[8] The following table gives a break-down of this profit:

Name of selling company	Number of shares sold	Total sales proceeds at $45 a share	Total cost at $10 a share	Net profit realized (350% upon cost)
International Securities Corporation of America	50, 000	$2,250,000	$500, 000	$1, 750, 000
Second International Securities Corporation	30, 000	1,350,000	300, 000	1, 050, 000
United States & British International Company, Ltd	20, 000	900,000	200, 000	700, 000
American & General Securities Corporation	19, 200	864,000	192, 000	672, 000
	119, 200	5,364,000	1, 192, 000	4, 172, 000

holders to subscribe at $45 a share to one additional share of common stock for each two shares held.[9] In view of the fact that the corporation's initial issue of stock less than nine months before had been made at $10 a share,[10] it was essential for Investment Trust Associates to show earnings, prior to the offering date of August 15, 1929, sufficiently impressive to justify the $45 price at which the rights were exercisable. Between August 10 and August 14, there occurred a series of transactions which enabled Investment Trust Associates to show, in the condensed balance sheet dated August 15 accompanying the announcement of the issuance of rights,[11] the desired results.

On August 10, 1929, Investment Trust Associates sold,[12] through Founders General Corporation, a block of 25,000 shares of United Founders Corporation stock at an average price of $63 a share, for a total of $1,573,730.[13] This stock had been acquired by Investment Trust Associates, in February 1929, at the "inside" price of $10.50 a share, or a total cost of $262,500.[14] Accordingly, Investment Trust Associates' profit on this sale was $311,230, or 500% above cost.[15]

On August 14, the day following the purchase by United Founders Corporation of the 119,200 share block of Investment Trust Associates stock, United Founders Corporation purchased directly from Investment Trust Associates 100,000 shares of Class B stock of American & General Securities Corporation at $14 a share.[16] Since this stock had been acquired by Investment Trust Associates in November 1928 at the "inside" price of $2 a share,[17] Investment Trust Associates obtained from United Founders Corporation a price seven times as great as it had paid and thereby realized a profit of $1,200,000, or 600% on cost.[18]

In addition, Investment Trust Associates at the same time sold to United Founders Corporation a block of 25,000 shares of Class A common stock of American & General Securities Corporation at $30 a share.[19] This stock had been acquired by Investment Trust Associates in November 1928 at $20 a share,[20] and therefore yielded Investment Trust Associates a profit of $10 a share, or an aggregate profit of $250,000.[21] Consequently, in this transaction in the stock of American & General Securities Corporation with United Founders Corporation, Investment Trust Associates recorded an aggregate profit of $1,450,000. Since, on its sale of United Founders Corporation stock on August 10, 1929, it realized profits of $1,311,230, its

[9] Op. cit. supra, note 4, Commission's Exhibit No. X3412 (D1). These rights were effective until September 10, 1929.

[10] For details, see supra, p. 2264. It will be recalled that 60,000 shares of Investment Trust Associates stock were taken down at $10 a share as late as the first quarter of 1929.

[11] Op. cit. supra, note 4, Commission's Exhibit No. X3412 (D1).

[12] Apparently to the public and to dealers.

[13] Op. cit. supra, note 4, Commission's Exhibit No. X3867.

[14] Id., Commission's Exhibia No. X3862. The details are discussed supra, p. 2258.

[15] Thus, instead of showing on its balance sheet 25,000 shares of United Founders Corporation stock at cost of $262,500, Investment Trust Associates was able to report cash of $1,573,730 and to credit "Undivided Profits" with the sum of $1,311,230.

[16] Op. cit. supra, note 4, Commission's Exhibit No. X3853.

[17] See supra, p. 2266, for details of this acquisition.

[18] Op. cit. supra, note 4, Commission's Exhibit No. X3853.

[19] Ibid.

[20] See supra, p. 2266.

[21] Op. cit. supra, note 4, Commission's Exhibit No. X3853.

aggregate realized profit arising out of intercompany dealings within the four-day period was $2,761,230. The following day, August 15, 1929, Investment Trust Associates issued to its stockholders the "rights" which have been alluded to. In the condensed balance sheet dated August 15, 1929, which accompanied the issuance of the rights, there appeared the sum of $3,589,785.59 as "Undivided Profits."[22] This indicated earnings of almost $9 a share in a period of less than nine months on a stock originally issued at $10 a share. Stockholders had no way of knowing from the published report that $2,761,230, or approximately 80% of these earnings, had been realized in the preceding four days in the extraordinary transactions of a nonrecurrent nature, described above.

If, to the $2,761,230 profits realized by Investment Trust Associates, there is added the $4,172,000 profit realized by the other four Founders companies on the sale, on August 13, 1929, to United Founders Corporation of their Investment Trust Associates stock, it is seen that the total profit recorded by various Founders companies within the four-day period, through intercompany transactions solely in the stock of Founders companies, was $6,933,230. Also to be noted is the manner in which various Founders companies were first the sources of "profits" to the other companies of the system (as in the case of Investment Trust Associates), and were subsequently themselves the beneficiaries of similar "profits" at the expense of other companies of the system, so that there was a constant ebb and flow of these "profits" within the system to window-dress the reports of the Founders companies and thereby to induce additional stock purchases by existing stockholders and the investing public.

It is noteworthy that immediately following the transactions which have been described, when Investment Trust Associates issued to its stockholders on August 15, 1929, the rights discussed above, the same four underlying Founders companies which two days earlier, on August 13, had sold to United Founders Corporation 119,200 shares of Investment Trust Associates stock, proceeded to purchase anew, through the exercise of rights, 39,000 shares of Investment Trust Associates stock (out of a total of 200,000 shares issued), paying therefor $1,755,200.[23] That these transactions formed part of a single plan carried out by the various units of an integrated system, is indicated by the testimony of Louis H. Seagrave:[24]

Q. Now, at that time we had one of those intercompany transactions in which International Securities, Second International, United States & British, and American & General Securities Corporation sold large blocks of their holdings of Investment Trust Associates to United Founders at $45 a share. Do you recall that?

A. I am trying to place myself. Was this after the rights had been issued and exercised?

Q. No.

A. Or before?

Q. Just about the time they were issued.

A. Well, Investment Trust Associates wanted to increase its capital fund. Some of its stockholders were International, Second International, and various companies of the group who had about as much an investment as they wanted.

Footnotes 22, 23, and 24 on p. 2279.

United Founders, however, which had been formed subsequent to the original sale of capital by Investment Trust Associates, had at that time no investment therein. The directors of United Founders Corporation met and considered whether they wanted to acquire this stock which these companies found if they exercised their rights would give them too large an interest in Investment Trust Associates. * * * Whether that was acquired in the form of rights which they exercised by paying for the rights, or whether these companies first exercised their rights and then sold the stock to United Founders, I have forgotten. You can tell me which it was. * * *

Q. But the effect of this transaction was to mark a recorded profit of $4,000,000 on the books of these companies?

A. That was inevitable. They paid $10 a share for the stock and they were selling it at around $45. If they sold it they had to take the profits.

By R. E. T. Riggs [counsel to the Founders companies]:

Q. At the same time, Investment Trust Associates, about that time, disposed of any remaining holdings that it had in any companies in the Founders group?

A. That is right.

Q. So that therefore it was to confine its investment and reinvestments to securities outside of the Founders group.

A. Outside the Founders group, as we understood it and described it. It included some affiliated companies.

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[22] Id., Commission's Exhibit No. X3412 (D1).

[23] The investment was increased from $2,263,540 to $2,826,740, a net increase of $563,200 and total profits of $4,299,123 ($4,172,000 plus $127,123) were realized. The position was changed from 226,354 shares (56%) of 400,000 outstanding to 146,154 shares (24%) of 600,000 outstanding shares. (Id., Commission's Exhibit No. X3412, D–1.) These 146,154 shares were sold out to United Founders Corporation on May 14, 1930 (see infra). The shift in the holdings of Investment Trust Associates stock on the part of the underlying Founders companies is analyzed in the following table:

	International Securities Corporation of America	Second International Securities Corporation	U. S. & British International Co.	American & General Securities Corporation	Total	Cost
Number of shares in portfolio before sale to United Founders Corporation [a]	97,154	50,000	40,000	39,200	226,354	$2,263,540
Number of shares sold to United Founders Corporation [b]	50,000	30,000	20,000	19,200	119,200	
Balance of shares on hand on which rights were received [a]	47,154	20,000	20,000	20,000	107,154	$1,071,540
Rights sold: [c]						
Number	17,154		8,000	4,000	29,154	
Amount (profit)	$74,623		$35,000	$17,500	$127,123	
Rights exercised: [a]						
Number of rights	30,000	20,000	12,000	16,000	78,000	
Number of shares	15,000	10,000	6,000	8,000	39,000	
At $45 a share	$675,000	$450,200	$270,000	$360,000	$1,755,200	$1,755,200
Total shares in portfolio after exercise of rights	62,154	30,000	26,000	28,000	146,154	$2,826,740

[a] Public Examination, American General Corporation, et al., Commission's Exhibit No. X3781.
[b] Id., Commission's Exhibit No. X3850.
[c] Id., Commission's Exhibit No. X3852.

[24] Op. cit. supra, note 4, at 26526–8.

b. Devices Employed to Circumvent Elimination of Intercompany Profits in Consolidated Financial Statements

It was shown in the previous section that after transferring to United Founders Corporation 119,200 shares of Investment Trust Associates stock, and acquiring 39,000 shares additional through the exercise of rights, the four underlying Founders companies concerned in these transactions held in their portfolios a total of 146,154 shares of Investment Trust Associates stock at a cost of $2,826,740.[25] In May 1930, these remaining 146,154 shares of Investment Trust Associates stock were transferred to United Founders Corporation for $4,524,924.84, resulting in an aggregate net profit of $1,698,187.84 for the four underlying Founders companies.[26]

According to Louis H. Seagrave, president of the United Founders Corporation and a director of each of the Founders companies involved, the transaction was effected in the interest of corporate simplification: [27]

Q. What ultimately happened with the Investment Trust Associates?

A. It was liquidated. At that time most of its stock was owned by United Founders Corporation. It was liquidated, and those few outside shareholders were paid off at the asset value as nearly as we could arrive at it.

Q. In what way had United Founders acquired the balance of the Investment Trust Associates stock?

A. They had made an offer to all the companies of the group that held any. The reason they wanted to acquire the stock was that we felt that it would be desirable to simplify the relationships in our companies and put the holdings of I. T. A. all in one company. United Founders was willing to own that company at a price, made the offer, and got the shares. Subsequently, however, we decided there was no particular reason for continuing its existence, inasmuch as the activities of that company and United Founders were very similar, and we liquidated it.

In effecting the transfer of this block of Investment Trust Associates stock from the underlying Founders companies to United Founders Corporation, it was found expedient, however, to pursue a somewhat devious course. For the six-month period ended May 31, 1930, United Founders Corporation published, for the first time, a consolidated statement of financial condition.[28] In this statement

[25] See note 23, supra.

[26] The following table gives the break-down of this profit (op. cit, supra, note 4, Commission's Exhibits Nos. X3857 and X3732) :

Sold by	Number of shares sold	Average cost per share	Total cost	Sales proceeds at $31 less taxes of 4¢ a share	Net profit realized
International Securities Corp. of America	62, 154	$18. 44	$1, 146, 540	$1, 924, 287. 84	$777, 747. 84
Second International Securities Corp.	30, 000	21. 67	650, 200	928, 800. 00	278, 600. 00
United States & British International Co., Ltd.	26, 000	18. 07	470, 000	804, 960. 00	334, 960. 00
American & General Securities Corp.	28, 000	20. 00	560, 000	866, 880. 00	306, 880. 00
Total	146, 154	19. 34	2, 826, 740	4, 524, 927. 84	1, 698, 187. 84

[27] Id., at 26529.

[28] Id., Commission's Exhibit No. X3420.

there were incorporated in integral fashion the reports of United Founders Corporation and of six subsidiary companies, including the four underlying Founders companies concerned in the transfer which is the subject of the present discussion.[29]

It is a well established principle of accounting practice that in the preparation of a consolidated income statement, profits should be eliminated which were derived from intercompany sales between the parent company and one or more subsidiary companies whose accounts are integrated in such consolidated statement, where the goods which were the source of the profit remain within the system.[30] Where there is, however, a substantial minority interest outstanding in the company which realized the profit, there is a difference of opinion among the authorities, some holding that there may be retained in the consolidated income account that proportion of the profit which is properly allocable to such minority interest.[31]

The general principle of elimination of intercompany profits was recognized and affirmed by the officers and accountants of the Founders companies who testified at the public examinations before the Commission.[32] It is manifest that the application of this accounting principle to the transfer of the 146,154 shares of Investment Trust Associates stock from the four subsidiary companies to the parent company (United Founders Corporation) on May 14, 1930, would have necessitated the elimination from the statement of May 31, 1930, of the profits aggregating $1,698,187 realized by the underlying companies in this transfer, or at least the elimination of all

[29] The subsidiary companies included in the consolidated statements were International Securities Corporation of America, Second International Securities Corporation, United States & British International Company, Ltd., American & General Securities Corporation, American Founders Corporation, and Investment Trust Associates.

[30] Kohler, E. L., "Some Tentative Propositions Underlying Consolidated Reports," Accounting Review, Vol. 13, March 1938, p. 63. Sanders, Hatfield and Moore, *A Statement of Accounting Principles* (1938), p. 106. Paton, W. A., editor, *Accountants' Handbook* (1932), p. 1039.

In Accounting Series, Release No. 7, the Chief Accountant for the Commission included among the deficiencies commonly cited by the Commission in connection with financial statements filed pursuant to the Securities Act of 1933 and the Securities Exchange Act of 1934, the failure to eliminate intercompany items from consolidated profit-and-loss statements or to explain satisfactorily the reasons for not eliminating such items. The rationale of this principle is avoidance of inventory write-ups. As stated by one authority, "the principle of property write-ups is contrary to one of the oldest conventions in accounting, i. e., that economic gains should not be reflected in the accounts until they are realized in cash or its equivalent." (Kohler, E. L., "Some Debated Issues on Consolidated Financial Statements," an article appearing in *Papers on Accounting Principles and Procedure,* p. 42 et seq., published by American Institute of Accountants, 1939.)

[31] Other authorities insist on the elimination of the entire profit, and several writers advocate retention of the entire profit in special circumstances. (See Kohler, E. L., "Some Debated Issues on Consolidated Financial Statement," and article appearing in *Papers on Accounting Principles and Procedure,* published by American Institute of Accountants, 1939.)

The percentage of common stock ownership by American Founders Corporation of its four underlying companies as of May 31, 1930, was as follows (op. cit. supra, note 4, Commission's Exhibit No. X3404–20):

	Class A Common	Class B Common
International Securities Corporation of America	92.6%	94.4%
Second International Securities Corporation	94.0%	96.3%
United States & British International Company, Ltd	95.4%	73.9%
American & General Securities Corporation	95.1%	93.5%

[32] See testimony, infra, p. 2352.

the profit not allocable to minority interests of the underlying companies.[33]

Confronted with the necessity of eliminating this intercompany profit of $1,698,187, the Founders management adopted a procedure of circumvention. The brokerage firm of D. H. Silberberg & Company was called in and was cast in the role of an intermediary.[34] D. H. Silberberg & Company, on May 15, 1930, purchased from American Founders Corporation (acting on behalf of its four subsidiaries) the 146,154 shares of Investment Trust Associates stock owned by the four underlying Founders companies, paying $31 a share, or a total of $4,530,774. The sum of $4,500,000 was loaned by United Founders Corporation to D. H. Silberberg & Company, in the form of a demand loan secured by the 146,154 shares of Investment Trust Associates stock as collateral. Eight days later, on May 23, 1930, D. H. Silberberg & Company resold the same 146,154 shares to American Founders Corporation (acting this time on behalf of its parent, United Founders Corporation) for $31\frac{3}{32}$ a share, plus taxes, or a total of $4,544,475.94.[35] The sale to D. H. Silberberg & Company was thereupon construed by the officers and accountants of the Founders Group to constitute a sale "outside the group," and not on an intercompany transaction. The profits of $1,698,187 realized by the four underlying Founders companies on whose behalf American Founders Corporation sold the stock, were thereupon included in the consolidated income statement of United Founders Corporation and subsidiaries for the six-month period ended May 31, 1930,[36] and again in the statement for the annual period ended November 30, 1930.[37] The details of the procedure followed in this transaction are revealed in the following testimony of David H. Silberberg:[38]

A. * * * We bought the securities [from American Founders Corporation] with the understanding that they would find a purchaser for us, apparently within a reasonable period of time, as indicated by the fact it was done within a week.

Q. You did not have the money to make that purchase, did you?

A. Obviously not; the money was borrowed.

Q. Who furnished the funds?

A. The United Founders.

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[33] It is to be noted that this problem did not arise with respect to the prior sale of 119,200 shares of Investment Trust Associates stock by the same four companies to United Founders Corporation in August 1929 (described in a preceding section), for the reason that United Founders Corporation did not commence to publish a consolidated statement until the period December 1, 1929–May 31, 1930. In the fiscal year ending November 30, 1929, although the four underlying Founders companies were subsidiaries of American Founders Corporation which owned almost all their voting stock, United Founders Corporation did not own a majority of American Founders voting stock, although it did have working control of the corporation. By the end of the fiscal period terminating May 31, 1930, however, American Founders Corporation had duly become a subsidiary of United Founders Corporation. Its subsidiaries were, therefore, likewise subsidiaries of United Founders Corporation, and the affairs of the entire group were consolidated, as has been pointed out, in the statement of May 31, 1930.

[34] Op. cit. supra, note 4, at 25232–7.

[35] Ibid.

[36] Id., Commission's Exhibit No. X3420–E4.

[37] Id., Commission's Exhibit No. X3420–E5.

[38] Id., at 25235–7.

Q. Did you know at the time you had the transaction that the funds would be furnished you to buy the securities by the person who was going to purchase them?

A. Not necessarily. They may have decided they wanted to have the American Founders sell them and another one of their companies, possibly, buy them.

Q. But you knew at that time that at the time you were merely the intermediary through which a transaction was made by which some companies of the group were going to sell to another company in the group, did you not?

A. Yes.

Q. And the $4,500,000 was borrowed by the United Founders, which subsequently became the purchaser, and furnished to you?

A. No; it turned out, apparently from my records here, that we bought the securities from the American Founders and sold them back to the American Founders, although the loan was made to us by United Founders.

* * * * * * *

Q. So far as you know, your records show that you bought these securities from the American Founders on May 15th, and on May 23rd you sold them to American Founders and the transaction was financed by a demand loan made to you by United Founders?

A. That is correct.

Q. At the time you bought from American Founders the financing had been arranged for you by the United Founders?

A. Yes.

Q. And you had a commitment at that time that you would sell those securities back, did you not?

A. I had a commitment at that time they would find a purchaser for me.

* * * * * * *

Q. * * * the fact is that the loan from the United Founders was made on May 15, 1930, and it was secured by 146,154 shares of Investment Trust Associates common, and after receiving that loan on May 17th, you then made your commitment to purchase from American Founders?

A. We then confirmed it.

* * * * * * *

Q. And this loan was a demand loan and was secured by the shares that you sold?

A. That is right.

In the manner recounted above, the 146,154 shares of Investment Trust Associates stock, passing through the brokerage offices of D. H. Silberberg & Company as through a conduit, came to rest in the portfolio of United Founders Corporation at a cost of $4,544,475.94.[39] This sum was $13,702 greater than the price received by American Founders Corporation eight days earlier.[40] At least one-half of this amount represented the cost to United Founders Corporation of receiving its Investment Trust Associates stock through the Silberberg conduit instead of through direct dealing.[41] Apparently this cost was not regarded as excessive for a device which presumably made possible

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[39] Id., Commission's Exhibit No. X3954.

[40] Ibid.

[41] Mr. Silberberg testified (id., at 25233) that his firm realized a gross profit of $7,858.78 (which interest charges reduced to $3,355.78 net), and that the federal taxes equaled $2,923 and state taxes $2,923.

the retention of an intercompany profit of $1,698,187, and the inflation of the investment account on the balance sheet.[42]

Lawrence P. Carron, treasurer of United Founders Corporation, as well as American Founders Corporation, who directed the transaction which is the subject of this discussion, testified to the effect that although he acknowledged the general principle of elimination of intercompany profits in consolidated statements he could not see "that through consolidating these companies with United Founders, that they should drop out [any] profit." Mr. Carron stated:[43]

A. * * * I thought that if there had been any sale to United Founders, that when you came to make a consolidated balance sheet there actually would have been a consolidated surplus, because the value of the assets of Investment Trust Associates coming into the consolidated picture was greater than the actual cost of the Investment Trust Associates shares to International. Furthermore, no matter to whom International had sold the Investment Trust Associates shares, to anyone, even to United Founders direct, it would have recorded a profit unquestionably, and on the consolidated balance sheet of American Founders and its subsidiaries, and there was a profit, and I couldn't see that then consolidating those companies with United Founders, that they should drop out profit. I just didn't think it would be unsatisfactory; I didn't think it could be done at all—couldn't.

Q. Well, you knew, of course, that a consolidated income statement was a common practice in complicated situations?

A. Oh, I know consolidated balance sheets were common practice. Furthermore, this was not a sale from a subsidiary to its direct parent. It was a sale or it would have been a sale from its grandchild to the parent; and that any dividend that would have been paid by International or Second International to American Founders would have been part of American Founders' surplus. Any dividend then paid by American Founders to United Founders would have been income to United Founders and part of United Founders' surplus, also—

* * * * * * *

Also, in the consolidated statements, when Investment Trust Associates became one of the consolidated companies, its portion of the earnings going into the consolidated earnings was only taken on the number of shares United Founders held before the acquisition of this extra 146,000 shares so there was no duplication of earnings there. Now, while there existed this general rule of consolidation, nevertheless I would have advocated that these be sold outside anyway for the purpose of establishing an outside sale, for the purpose of establishing the price, actual price, which was the market at the time, even though it was Silberberg. He was certainly satisfied that that represented the market at the time. He must have been satisfied that that represented the market at the time, and I think that it would have been good in the consolidated income without the sale to Silberberg.

The testimony of W. H. Conkling, member of the firm of Loomis, Suffern & Fernald, certified public accountants who certified the consolidated statements of United Founders Corporation in 1930, reveals

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[42] This inflation was reflected in the consolidated balance sheet (id., Commission's Exhibit No. X3420) either in capital surplus account (see testimony of Lawrence P. Carron, id., at 22604–9) or in the account entitled "cost of securities of subsidiary companies in excess of their stated values," depending on whether the cost of acquisition of the stock by United Founders Corporation exceeded, or was less than, the aliquot interest represented by these shares in the assets of Investment Trust Associates.

[43] Id., at 26607–9.

that these accountants were entirely content to regard merely the form of the transaction, and felt no obligation to give consideration to its substance:[44]

Q. Mr. Conkling, limiting our discussion to the general principle of consolidation where an intercompany transaction occurs between a parent and subsidiary company in securities, as a result of which the subsidiary company realizes a profit from the sale to the parent company, consolidation for the purposes of the consolidated income statement would require that it set forth the amount of income ascribable to the minority interest, those profits would be eliminated in consolidation, would they not?

A. Yes.

Q. Would a transaction whereby the securities were passed through an outside intermediary with an assurance to that intermediary that the seller or agent for the seller would find a purchaser for the securities take it outside of that group?

A. Yes, sir.

Q. On what theory?

A. The sale outside the group.

Q. But where an assurance that the seller would take back the securities or find someone to buy them, is that outside the group?

A. I don't know. With the assurance the seller would find a purchaser?

Q. Yes.

A. That still keeps it outside the group. If the seller agrees to buy it back, it might give rise to a different situation.

Q. The situation we have here, Mr. Conkling, is that on May 15, 1930, the American Founders Corporation, representing four subsidiary companies, sold to a broker 146,154 shares of Investment Trust Associates. United Founders, which was the parent company of American Founders, made the loan to enable the broker to handle that. The broker admitted he could not have afforded to do it without that loan. The broker admitted that he had assurances at the time he made the purchase that they would find a seller for it. On May 23rd, eight days later, the securities were sold to United Founders Corporation, represented by American Founders, the same number of shares, and a profit recorded. Do you think that the handling of the matter in that way would justify taking the matter out of the principle of consolidation you have referred to?

A. Yes; a definite sale outside the consolidation, title passes, and so forth, all the requisites of the sale, as we understand it passes.

Q. You have pointed out the way the principle of consolidation can be easily avoided. All you have to do is finance the purchase and sell it back.

A. Possibly.

Q. But you still think it is a sound principle?

A. I think that particular transaction you are talking about is all right—perfectly sound.

Q. Do you think the profits that resulted from a turnover should be treated like other profits and not marked off, or differentiated or earmarked?

A. I know of no particular reason for earmarking or separating.

Q. You know, Mr. Conkling, it is simply a shuffling of the cards, don't you?

A. If there is a definite intention to buy those securities back, and it is not a real sale, it is a different proposition. Now, this was a definite sale outside the group, if I understand correctly.

Q. I want to know what your opinion as an independent public accountant of standing is as to this kind of transaction. You have stated if there has been a plain sale from one to the other, there would have been no realized profits that

[44] Id., at 26722–5.

would survive consolidation, but, on the other hand, by this little device of passing it through someone who protected you all along there is a realized profit and that profit should not be earmarked.

A. Yes, sir.

Q. That is your considered judgment?

A. Yes, sir.

Q. And you look at it the same way today?

A. Yes, sir.

It is readily apparent that if the views of Mr. Conkling were to achieve wide currency in the accounting profession, they would effectively spell an end to the doctrine of elimination of intercompany profits, for, by the simple device of resorting to the type of "conduit sale" described above, the way would be open to inflate income and investment accounts, and thereby to destroy the accuracy and reliability of the consolidated financial statement.[45]

c. Nondisclosure of Successive Intercompany Profits in Class B Stocks of International Securities Corporation of America and Second International Securities Corporation

In November 1926, American Founders Corporation (at the time called American Founders Trust) acquired from International Securities Corporation of America 600,000 shares of the latter's Class B common stock, paying therefor $3.70 a share in cash. American Founders Corporation was at that time the fiscal agent for International Securities Corporation of America. On the theory that it had surrendered certain valuable options and rights in consideration of the acquisition of this Class B stock at $3.70 a share, and that the shares entailed additional items of cost, American Founders Corporation placed a book value on this stock of $8.62 a share. Although the history of these shares is discussed in a subsequent part of this study,[46] the present section will trace the movements of one block of 20,000 shares of this Class B stock of International Securities Corporation of America.

American Founders Corporation carried these Class B shares on its books, as has been stated, at $8.62 a share, or an aggregate value of approximately $172,400 for the 20,000 shares here under consideration.[47] In 1928, American Founders Corporation disposed of these 20,000 shares; but, in 1930, these shares were back in the portfolio of American Founders Corporation at a new cost valuation of $714,000. This $541,600 enhancement was accomplished in the following steps:

---

[55] Franklin Bowman, a member of the accounting firm of Haskins & Sells, whose name appeared on the United Founders reports for the year 1930 as "consulting accountants," was willing to concede, at least "in the light of present-day experiences," that attention should be specifically directed in the report by the accountants to a transaction of the kind described above. He testified (id., at 26817):

> Q. * * * Don't you think that that kind of a transaction, if a profit is registered in it, should be separately noted by some footnote of some kind?
>
> A. Well, I think, in the light of present-day experiences I would say it should be.

[46] This subject is treated in detail infra, p. 2374.

[47] See infra, p. 2374.

On September 28, 1928, American Founders Trust sold 5,000 shares of Class B International Securities Corporation of America stock to United States & British International Company, Ltd., and 15,000 shares to Second International Securities Corporation at $25 a share for a total of $500,000 with a consequent book net profit to American Founders Trust of $327,600.[48] On November 20, 1928, Second International Securities Corporation sold 5,000 shares to Investment Trust Associates at $30 a share, thereby gaining a profit of $25,000.[49] On November 27, 1929, Second International Securities Corporation sold 2,000 shares additional to Investment Trust Associates at $30 a share, making a further profit of $10,000.[50] On February 25, 1929, United States & British International Company, Ltd. sold its holdings of 5,000 shares to United Founders Corporation at $35.70 a share, realizing a profit of $53,500.[51] On the same day Investment Trust Associates sold to United Founders Corporation 5,000 shares at $35.70, realizing a profit of $28,500. On February 28, Second International Securities Corporation sold to United Founders Corporation its remaining 8,000 shares at $35.70 a share, for a profit of $85,600. On March 12, 1929, Investment Trust Associates sold to United Founders Corporation its remaining 2,000 shares at $35.70 a share, for an additional profit of $11,400. On April 21, 1930, United Founders Corporation resold the entire 20,000 shares to American Founders Corporation at the price it had paid, $714,000.[52]

In this manner, these 20,000 shares of International Securities Corporation Class B stock finally returned to the portfolio of American Founders Corporation at a "cost" valuation more than four times as great as that at which they were carried at the time they commenced their circuit. In the course of their wanderings solely within the framework of the Founders Group, these stocks inflated the income accounts of the various Founders companies to the extent of $541,600, of which $327,600 was realized by American Founders Corporation itself.[53] Thus, nearly one-half the amount at which American Founders Corporation carried these shares in its portfolio represented "profits" by American Founders Corporation, and were reported as such in its income account.

Similar in outline to the foregoing incident is the record of intercompany profits realized by the Founders companies from a block of 11,000 shares of Class B stock of Second International Securities Corporation. These shares formed part of a block of 600,000 shares of Class B stock of Second International Securities Corporation acquired at $3.267 a share by American Founders Corporation when the former corporation was organized in 1926.[54] These shares, like those of International Securities Corporation of America, described above, were disposed of by American Founders Corporation in 1928, and after passing through the portfolios of several other Founders companies, leaving a profit with each, they returned to the portfolio of American Founders Corporation in 1930 at a "cost" valuation $241,263 greater than that which they originally had.[55] An important element in this enhancement in cost was the profit of $95,497.50 realized by American Founders Corporation itself on its initial sale of the stock.[56]

[48] Op. cit. supra, note 4, Commission's Exhibit No. X3882.

[49] Ibid. [50] Ibid. [51] Ibid.

Footnotes 52, 53, 54, 55, and 56 on pp. 2288–89.

[52] This series of shifts is portrayed in the following table (id., Commission's Exhibit No. X3882):

Transactions by Founders companies in International Securities Corporation of America class B shares

Date	Transaction	Lot	Shares	Price per share	Total sales price	Cost of sales	Profit	Original acquisition cost	Book value carried in portfolio of American Founders Corp.
1926 Nov. 23	Acquired from Int'l Sec. Corp. of America in lot of 600,000 shares by American Founders Trust		20,000	$8.62*				$172,400	
1928 Sept. 28	American Founders Trust sold to U. S. & British Int'l Co., Ltd		5,000	25.00	$125,000	$43,100	$81,900		
1929 Feb. 25	U. S. & British Int'l Co., Ltd. sold to United Founders Corp	(A)	5,000	35.70	178,500	125,000	53,500		
1928 Sept. 28	American Founders Trust sold to Second Int'l Sec. Corp		15,000	25.00	375,000	129,300	245,700		
Nov. 20	Second Int'l Sec. Corp. sold to Investment Trust Associates		5,000	30.00	150,000	125,000	25,000		
Nov. 27	Second Int'l Sec. Corp. sold to Investment Trust Associates		2,000	30.00	60,000	50,000	10,000		
1929 Feb. 25	Investment Trust Associates sold to United Founders Corp	(B)	5,000	35.70	178,500	150,000	28,500		
Mar. 12	Investment Trust Associates sold to United Founders Corp	(C)	2,000	35.70	71,400	60,000	11,400		
Feb. 28	Second Int'l Sec. Corp. sold to United Founders Corp	(D)	8,000	35.70	285,600	200,000	85,600		
					1,424,000	882,400	541,600	172,400	
	Original acquisition cost								$172,400
	Profits thereon								541,600
1930 Apr. 21	Above 20,000 shares acquired by United Founders Corp., being lots A, B, C, and D, sold to American Founders Corp. at cost to United Founders Corp. (being included in lot of 44,100 shares—see commission's exhibit No. X4276)						541,600	172,400	714,000

*Cash Cost 3.7037
Capitalized expense 4.92

Carrying value 8.62

[53] Id., Commission's Exhibit No. X3882.

[54] This acquisition is discussed, infra, p. 2374.

[55] Op. cit. supra, note 4, Commission's Exhibit No. X3883.

[56] Details of the course followed by this block of stock until its return to American Founders Corporation portfolio are indicated by the following schedule (id., Commission's Exhibit No. X3883):

Transactions by Founders companies in Second International Securities Corporation class B shares [a]

Date	Transaction	Lot	Shares	Price per share	Total sales price	Cost of sales	Profit	Original acquisition cost	Book value carried in portfolio of American Founders Corporation
1926									
---------	Originally acquired from Second Int'l Sec. Corp. in a lot of 600,000 shares	----	7,500	$3.267	--------	----------	----------	$24,502.50	----------
1928									
Oct. 31	American Founders Corp. sold to U. S. and British Int'l Co., Ltd	----	7,500	16.00	$120,000	$24,502.50	$95,497.50	----------	----------
Nov. 21	U. S. & British Int'l Co., Ltd., sold to Investment Trust Associates	----	3,000	20.00	60,000	48,000.00	12,000.00	----------	----------
Nov. 26	Investors General Corp. (a Coombs Holding Corp.) sold to Investment Trust Associates	----	3,500	20.00	--------	----------	----------	70,000.00	----------
1929									
Feb. 25	Investment Trust Associates sold to United Founders Corp	(A)	5,000	25.20	126,000	100,000.00	26,000.00	----------	----------
Mar. 22	Investment Trust Associates sold to United Founders Corp	(B)	1,500	25.20	37,800	30,000.00	7,800.00	----------	----------
Feb. 25	U. S. & British Int'l Co., Ltd., sold to United Founders Corp	(C)	4,500	25.20	113,400	72,000.00	41,400.00	----------	----------
					457,200	274,502.50	182,697.50	94,502.50	
---------	Original acquisition cost	----	-------	------	--------	----------	----------	----------	$94,502.50
---------	Add profit thereon	----	-------	------	--------	----------	----------	----------	182,697.50
1930									
Apr. 30	Above 11,000 shares acquired by United Founders Corp., being Lots A, B, and C, sold to American Founders Corp. at cost to United Founders Corp. (being included in a lot of 41,500 shares). See Commission's Exhibit No. X4276	----	-------	------	--------	----------	182,697.50	94,502.50	277,200.00

[a] Not specifically indicated in this schedule is a profit realized by American Founders Corporation upon the 3,500 shares sold by Investors General Corporation to Investment Trust Associates. Although the details of this transaction are not on record, in view of the fact that the entire issue of Class B shares of Second International Securities Corporation originally was in the portfolio of American Founders Corporation at a cost value of $3.267 a share, and in view of the fact that it is a matter of record that none of these shares were disposed of by American Founders Corporation at less than $16.00 a share, American Founders Corporation must necessarily have realized a profit of at least $12.733 a share, or $44,565.50, upon the 3,500 shares which were acquired by Investors General Corporation.

Louis H. Seagrave, president of both American Founders Corporation and United Founders Corporation, and a director of all the Founders companies concerned in these transactions, when examined with respect to these transactions, conceded that the "set-up" of the Founders Group was susceptible of abuse in the matter of intercompany profits and that "one of the difficulties in a group of companies like this is that it is literally impossible to deal completely at arm's length, no matter how you try": [57]

A. * * * As to my feeling on that, I think I agree that one of the difficulties in a group of companies like this is that it is literally impossible to deal at completely arm's length, no matter how you try. Therefore, there is always the possibility that an error in judgment may have been made on one side or another in a transaction between closely affiliated companies. I would rather not see it.

* * * * * * *

Q. * * * and that is one of the difficulties I find in this particular set-up. I am just curious to know that when you have the same investment adviser, when you talk about scientific investment advice, why it is with the same adviser, with no purpose on the one hand to control or on the other hand to sell the control, what are the motivating factors?

* * * * * * *

A. These companies were all companies that had their particular problems. They had different dividend dates. Some of them had made their principal investments in some years and some in others. In some cases it may seem advisable to change them, and in others it may not. I remember times when some of the companies sold securities because they needed cash with which to pay their dividends. I can remember when we found some companies with a little more cash, though perhaps not any more proportionately, than others, and yet a particular investment came along that necessitated, if they participated on the same basis, disposing of something else. Their capital structures were somewhat different. As the result there were times when we believed it highly advisable to keep larger amounts of bonds in some companies than in others, their investments were not identical. So that always there were different problems arising in these companies. It was not a case of a rational happening, it was happening week in and week out, year in and year out.

* * * * * * *

Q. I am desirous, Mr. Seagrave, of letting you know exactly the purpose of these questions. We have here the beginning of a technique that became very much in evidence in the year 1929. In the years 1928, 1929, and 1930 the substantial profits of the group, such as they were, were in these switching operations, were in the dealings of the group in the securities issued by the companies in the group.

A. I have made some analysis of those and I am perfectly willing to discuss them specifically as they come up, but I do not quite agree with the statement you have just made.

Q. We will give you an opportunity, in the discussion of those, where we will take up that matter, because I think that is one of the interesting phenomena in this whole Founders situation, and it seems to me was one of the things that might well have caused thought on the part of the directors at the time. But at this time, at this moment, I am directing your attention to the 1928 transactions, which were the forerunners of transactions which multiplied in number

[57] Id., at 24097 et seq.

and in size, in the amount of profit. I am asking you whether there is any other reason that suggests itself to you other than the fact that you expected, that you think that possible differences in dividend dates might have dictated these transactions?

Mr. RIGGS [counsel for the Founders companies]:

He said more than that. Difference in dividend dates, difference in requirements of cash, difference in investment policies, the necessity of the sale of some securities to invest in others, various reasons. They have all accounted for it. It is the particular transaction as to which he said he could not generalize—I mean, generalize as to the whole.

Q. You think that it was those considerations and not a desire to show profit that dictated these purchases and sales in securities?

A. I am not going to deny there were times when we were looking over the portfolio of the companies and saw an opportunity to take a profit that we did not take it, and it was a very customary thing at the year end for the investment department to analyze the position, whether the question was to allow the unrealized appreciation or the right to sell some security, and undoubtedly there were times when we did precisely that. That, I think, is in addition to what I have previously said.

Q. Mr. Seagrave, of course the situation was such that if you had unconscientious people running these corporations it was perfectly possible to enable a corporation to take a profit in the securities of another corporation, as long as the market was going well, almost without any difficulty, just the turn of the hat. Is that not so?

A. Well, theoretically that is true; yes. I think there would be many obstacles to an improper application of it.

Q. But there is no doubt about it that this set-up, with an investment management corporation on top and various subsidiaries below that corporation, and with a distributing corporation that made a market in the securities of both the top companies and the affiliates, that you had an ideal set-up for that sort of thing if you wanted to do it. Is not that true?

A. The materials, the set-up, as you call it, were there.

Under the questioning of Royal E. T. Riggs, of counsel for the Founders companies, Mr. Seagrave testified:[58]

Q. United Founders upon its organization obtained some of the B shares of the investment companies, International, Second International, United States & British, and American General, subsequently American Founders, became the parent of those four companies, and after that it was determined by the management that it would be better to concentrate in American Founders all of the securities in the direct subsidiaries of American Founders?

A. That is correct.

Q. And that was the reason that those transactions were effected, isn't it?

A. That's right.

d. Nondisclosure of Intercompany Profits on Sale of United States Electric Power Corporation Warrants

In a subsequent section a detailed account is rendered of the profits derived by the Founders Group from the distribution of the securities of United States Electric Power Corporation.[59] One incident

[58] Id., at 26634–5.

[59] See infra, p. 2314.

collateral to this distribution is touched on briefly at this point because of its relation to the subject of profits derived from intercompany dealings.

A block of 60,000 warrants of United States Electric Power Corporation had come into the possession of five companies of the Founders Group.[60] In May 1930, these five Founders companies transferred the block of 60,000 warrants to Founders General Corporation for net proceeds of $298,800, all of which represented a profit to the selling companies.[61] Founders General Corporation, purchaser of these warrants at a price which yielded the selling companies profits of approximately $300,000, was itself the wholly owned subsidiary of American Founders Corporation. American Founders Corporation, it has been pointed out, was at the same time the parent of four of the selling companies and an affiliate of the fifth. Following this transaction, these warrants rested in the portfolio of Founders General Corporation for several years.[62]

e. Nondisclosure of Intercompany Profits of American Founders Corporation From Sale of Class B Stock of United States & British International Company, Ltd.

In January 1928, American Founders Corporation acquired a large block of Class B stock of United States & British International Company, Ltd., concurrent with the latter's organization, paying therefor $3.33⅓ a share.[63] During the balance of 1928 American Founders Corporation continued to add to its holdings of United States & British International Company, Ltd., Class B stock at rising prices, until by November 1928 the average cost for its holdings of this stock was $5.71 a share.[64]

In November 1928, Investment Trust Associates was taken over and reorganized within the framework of the Founders Group as an investment company of the management type, and it was announced

[60] Op. cit. supra, note 4, Commission's Exhibit No. X3887. Four of these companies were subsidiaries of American Founders Corporation, and the fifth was an affiliate. The four subsidiaries were: International Securities Corporation of America, Second International Securities Corporation, United States & British International Company, Ltd., and American & General Securities Corporation. Together these four subsidiaries owned 50,000 warrants. The affiliated company, Investment Trust Associates, owned 10,000 warrants.

[61] Id., Commission's Exhibit No. X3887.

[62] Id., Commission's Exhibit No. X3888. The details of the transactions are summarized as follows (id., Commission's Exhibit No. X3887):

United States Electric Power Corporation warrants delivered to Founders General Corporation by—	Number of detached warrants delivered at $5 a warrant less tax	Net proceeds received, representing profits
International Securities Corporation of America	20,000	$99,600
Second International Securities Corporation	10,000	49,800
United States & British International Company, Ltd	10,000	49,800
American & General Securities Corporation	10,000	49,800
Investment Trust Associates	10,000	49,800
	60,000	298,800

[63] Id., Commission's Exhibit No. X3409–C.

[64] Id., Commission's Exhibit No. X3884.

that American Founders Corporation would supply investment service to the new Founders company without charge.[65]

On November 30, 1928, the last day of its 1928 fiscal period, American Founders Corporation transferred to Investment Trust Associates 10,000 shares of Class B stock of United States & British International Company, Ltd., at $17.00 a share.[66]

In computing its profit on this sale, American Founders Corporation was first required to decide how much the securities sold had cost it. In similar cases in the past, American Founders Corporation had always employed the "average-cost" basis,[67] that is, the cost of the securities sold was assumed to be the average unit cost of its entire holdings which in this case was, as has been said, $5.71 a share. For example, on November 19, 1928, less than two weeks before the sale to Investment Trust Associates, American Founders Corporation had sold a small lot of 200 shares of Class B stock of United States & British International Company, Ltd., at $19.00 a share,[68] and, in computing its profits on this sale, had, as was its custom, employed the "average-cost" basis. Calculated on the average cost basis of $5.71 a share, its net profit on the 200 shares was $13.28 a share, or a total of $2,656.74.[69]

In the case of the sale to Investment Trust Associates, however, American Founders Corporation abandoned its usual practice and computed the cost of the stock on the "first in—first out" basis; that is, it assumed that the 10,000 shares sold formed part of its initial purchase which was at the price of only $3.33⅓ a share. On this basis, it entered a profit of $13.66 a share, or $136,666.67 on the 10,000 shares.[70] If, as consistency required, the "average-cost" basis had been used, the profit reported by American Founders Corporation in its statement for the period ending November 30, 1928, would have been $112,835.67, a difference of $23,830.

Until the sale of this block of 10,000 shares, American Founders Corporation had been steadily accumulating Class B stock of United States & British International Company, Ltd., during 1928,[71] so that the motive for the sale on November 30 seems inexplicable unless it be attributed to a desire on the part of American Founders Corporation to enter a profit for the fiscal year 1928, which closed on the very day of the sale.[72]

Support is lent to this theory by the subsequent history of the 10,000 shares purchased from American Founders Corporation by Investment Trust Associates. These shares remained in the portfolio of Investment Trust Associates from November 30, 1928, until February

[65] The announcement stated (id., Commission's Exhibit No. X3412–E): "The organization will command the investment advice and favor of American Founders Corporation. No charge will be made for investment service, and its officers and directors, most of whom are in the service of American Founders Corporation, or affiliated companies, will serve without compensation."

[66] Id., Commission's Exhibit No. X3884.

[67] Id., Commission's Exhibit No. X3409.

[68] Id., Commission's Exhibit No. X3884.

[69] Ibid.

[70] Ibid.

[71] See supra.

[72] For other instances of "window-dressing" of Founders companies' statements, particularly at the end of 1928, see supra, p. 2250.

4, 1929, a period of a little more than two months. On the latter date the shares were shifted to the portfolio of Founders General Corporation at a profit of $2,100 for Investment Trust Associates.[73] Since Founders General Corporation was a wholly owned subsidiary of American Founders Corporation, the shares, in effect, rested once again under the control of American Founders Corporation, where they remained for almost the balance of the year 1929.[74] In November 1929, together with other shares, they were sold by Founders General Corporation at a small profit.[75] But in December 1929, a month later, Founders General Corporation commenced accumulation of a block of 9,944 shares of United States & British International Company, Ltd., which were acquired at an average price of $10.64 a share. In the following months Founders General Corporation accumulated additional shares, and on March 26, 1930, it turned over to American Founders Corporation at cost a block of 12,115 shares of United States & British International Company, Ltd., at $11.63 a share.[76] Thus, American Founders Corporation, having recorded a profit of $136,666 on a block of 10,000 shares during the fiscal year 1928, nevertheless retained control of this stock during most of 1929 and held an even greater number of these shares in its portfolio in 1930.

Concerning these transactions Louis H. Seagrave testified:[77]

Q. According to this exhibit 3930, you bought some 33,000 in October and November, and then you sold in November, 10,200; and, as a matter of fact, that sale was just in time for American Founders to register a profit of $139,000 on its balance sheet for November 1930 [1928] in its income account. Now, do you recall the transaction?

A. No; I do not.

Q. Perhaps I can refresh your recollection by calling to your attention that the sale was made to Investment Trust Associates?

A. I am glad you reminded me of that, because that was at practically the time of the formation of Investment Trust Associates.

Q. That was practically at the time of the formation of Investment Trust Associates, so that was a purely intercompany transaction, that is, a sale from one of the companies in the Group to another company in the Group, and a profit registered accordingly?

A. Well, it was a sale by American Founders which, as I recall, at the time did not have any investment in I. T. A.

Q. You don't mean to imply that I. T. A. was outside of the Group?

A. Not at all, I am merely mentioning that point of distinction.

Q. Its officers were largely the officers of American Founders, and its directors were largely the directors—

A (interposing). I think every company of the Group was represented on the Board.

Q. And the other companies in the group had substantial investments in I. T. A.?

A. Correct.

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[73] Op. cit. supra, note 4, Commission's Exhibit No. X3885.

[74] Id., Commission's Exhibit No. X3886.

[75] Ibid.

[76] Ibid.

[77] Id., at 24025–7.

Q. And you don't mean to imply that there was the same arm's length dealing between I. T. A. and American Founders that there was between American Founders and United States Steel Corporation?

A. No; I didn't mean to imply that.

f. Recapitulation of Intra-Group Trading Through Investment Trust Associates

The successive parts played by Investment Trust Associates in several of the transactions described above have been integrated in the schedule which is appended below.[78] It will be observed in this schedule that in each transaction the shares involved therein started out from the portfolio of American Founders Corporation and, after a journey of greater or lesser extent, returned once again to the portfolio of American Founders Group via Investment Trust Associates. Taking the combined total of the five blocks of stock included in the schedule, it is seen that these shares had an aggregate cost value of $814,908.50 at the time they set forth on their respective trips, and an aggregate cost value of $2,348,300 when they finally returned to the portfolio of American Founders Corporation or to that of its subsidiary, Founders General Corporation. The inflation in cost value,

[78] Id., Commission's Exhibit No. X3889.

Shares Sold and Reacquired via Investment Trust Associates by American Founders Corporation [a]

Title of security	Number of shares	Cost of shares disposed of by American Founders Corp.		Cost at which reacquired by American Founders Corp.		Total profits realized on sales
		Per share	Total	Per share	Total	
American & General Sec. Corp.: Class A Common	25,000	$20.00	$500,000.00	$30.00	$750,000	$250,000.00
American & General Sec. Corp.: Class B Common	100,000	2.00	200,000.00	10.125	1,012,500	812,500.00
Int'l Sec. Corp. of America: Class B Common	7,000	8.62	60,340.00	35.70	249,900	189,560.00
Second Int'l Sec. Corp.: Class B Common	6,500	3.267	21,235.50	25.20	163,800	142,564.50
U. S. & British Int'l Co., Ltd.: Class B Common	[a] 10,000	3.333	33,333.00	17.21	172,100	138,767.00
			814,908.50		2,348,300	1,533,391.50

Title of security	Profits (losses) realized by					
	American Founders Corp.	Investment Trust Associates	United Founders Corp.	Second Int'l Sec. Corp.	U. S. & British Int'l Co.	Investors General Corp.
American & General Sec. Corp.: Class A Common		$250,000				
American & General Sec. Corp.: Class B Common		1,200,000	($387,500)			
Int'l. Sec. Corp. of America: Class B Common	$114,660.00	39,900		$35,000		
Second Int'l. Sec. Corp.: Class B Common	82,764.50	33,800			$12,000	$14,000
U. S. & British Int'l. Co., Ltd.: Class B Common	136,667.00	2,100				
	334,091.50	1,525,800	(387,500)	35,000	12,000	14,000

[a] Reacquired by Founders General Corporation, a wholly owned subsidiary.

amounting to $1,533,391.50, represented intercompany profits derived by each of the founders companies through whose portfolios the shares passed in the course of their respective tours. Of this sum, $334,091.50 represented sums which American Founders Corporation itself treated as "profits" and placed in its income account, thereby participating to that extent in the process of inflating the price at which the shares were reacquired by it.

Manifestly, sound accounting practice either should not have permitted that this sum of $334,091 be treated as profit at all; or, if it had been entered in income account, that amount should subsequently have been credited to reduce the new cost of the investment upon repurchase. Where a company sells stock to a subsidiary and close affiliate at a profit and later repurchases the same stock at an increased price, if the company is permitted to enter the stock in its investment account at the new cost and to retain its earlier profit in income account, the result would constitute an effective circumvention of one of the oldest of the accounting precepts—the rule against write-up of assets.[79] On this subject, Leland Rex Robinson, author of the book *Investment Trust Organization and Management*, who was president of Second International Securities Corporation and a director of American Founders Corporation, testified:[80]

Q. When American Founders has stock on its books at 20 and sells to Investment Trust Associates at 25 and takes it back at 25 and registers a profit of 5, is that any real profit?

A. Of course not. Profits only come when you are dealing with a free market.

Q. You made that perfectly clear in your book?

A. I want to make it clear now. It is a personal conviction, of course.[81]

3. FAILURE TO SEGREGATE AND REVEAL SUMS DIVERTED FROM CAPITAL ACCOUNTS TO INCOME ACCOUNTS OF AMERICAN FOUNDERS CORPORATION AND UNITED FOUNDERS CORPORATION THROUGH FOUNDERS GENERAL CORPORATION

In February 1928, Founders General Corporation was organized to take over from American Founders Corporation the dual functions of distributing the securities of the companies in the Founders System and of making and maintaining a continuous market in these securities.[1] These functions Founders General Corporation per-

[79] See note 30, supra.

[80] Public Examination, American General Corporation, et al., at 24919.

[81] Dr. Robinson's testimony is set forth in detail infra, p. 2362.

[1] Public Examination, American General Corporation et al., at 24103 et seq. Thomas H. Benton, vice president of Founders General Corporation, defined the functions of the company as follows (id., at 24530):

A. The functions of Founders General were to trade in the securities and also distribute the securities of the American Founders Group.

Q. And was there also, as part of their duties, the policing of the market?

A. That would come under the heading of trading. Mr. Benton also testified (id., at 24535):

Q. In reality, then, you made the market daily, from the last trades and sales you established the price that the stock would be quoted at the next morning, from day to day.

A. I wouldn't say that we actually established it; we influenced the prevailing price quite a lot, I would say, by our activities on the stock.

The circumstances surrounding the formation of Founders General Corporation and its relation to the Founders Group are discussed in the testimony of Louis H. Seagrave and Royal E. T. Riggs, in Appendix C.

formed to some extent for the various underlying and affiliated companies of the Founders Group, but its chief activities revolved about the two top companies, American Founders Corporation and United Founders Corporation.[2] Transactions by Founders General Corporation in the securities of American Founders Corporation possessed a special character, for Founders General Corporation was a wholly owned subsidiary of American Founders Corporation.[3] Therefore, dealings by Founders General Corporation in the securities of American Founders were tantamount to dealings by American Founders Corporation in its own capital stock, and the sums derived from such dealings were in reality not profits but credits to capital.

Much the same character appertained to activities by Founders General Corporation in the securities of United Founders Corporation, for although United Founders Corporation did not acquire absolute majority control of American Founders until March 1930,[4] from its very inception in February 1929, United Founders Corporation possessed effective working control of that corporation.[5] By virtue of its control of American Founders Corporation, United Founders Corporation likewise effectually controlled the latter's wholly owned subsidiary, Founders General Corporation. Accordingly, United Founders Corporation had effective control of the trading activities of Founders General Corporation in United Founders Corporation's own securities, and the sums derived from such activities represented not profits, but portions of United Founders' contributed capital.

Moreover, not only were American Founders Corporation and United Founders Corporation in control of the trading activities of Founders General Corporation in their securities, but in their capacity as parent companies they were substantial participants in the ample sums recorded as profits by Founders General Corporation from trading in and distributing their capital shares. This participation occurred in the following manner: Founders General Corporation paid extraordinary sums in dividends to its parent company, American Founders Corporation, derived principally from the approximately $10,000,000 of profits realized by Founders General Corporation from dealings in the common stock of United Founders Corporation.[6] American Founders Corporation was in turn able to pay substantial dividends to United Founders Corporation, in part from these dividends derived from profitable dealings in the capital shares of United Founders Corporation.

Thus in 1929, Founders General Corporation realized the sum of $7,704,580.11 as "profits" from the sale of the common stock of United Founders Corporation,[7] not including $916,770.37 as commissions

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[2] In 1929 Founders General Corporation bought and sold securities of American Founders Corporation in the approximate amount of $100,000,000 (id., Commission's Exhibit No. X3894) and securities of United Founders Corporation in the approximate amount of $238,-190,954 (id., Commission's Exhibit No. X4291). In 1930 its dealings in the securities of United Founders Corporation approximated $77,024,810. (Ibid.)

[3] Id., at 24103 et seq., and Commission's Exhibits Nos. X3404 (E–2, E–3) and X3415.

[4] Id., at 26605 and Commission's Exhibit No. X3690 (p. 2).

[5] See statement of Louis H. Seagrave. (Id., Commission's Exhibit No. X3840 (p. 9).)

[6] Id., Commission's Exhibit No. X3415, Schedules 20–A1 and 20–A2.

[7] Ibid.

from the same source.[8] Founders General Corporation paid as dividends in 1929, mainly from "profits" on its dealings in United Founders Corporation stock,[9] the sum of $4,961,750.[10] This represented a return to American Founders Corporation on its common stock investment (Class A and Class B) as of October 17, 1929, of 805%.[11]

In point of fact, these "dividends" paid by Founders General Corporation to American Founders Corporation, which in turn made possible dividends from American Founders Corporation to United Founders Corporation, were for the most part contributed capital of United Founders Corporation which had been diverted to Founders General Corporation as "commissions" on distribution of United Founders stock to the public. When these capital contributions were later passed along to American Founders Corporation and United Founders Corporation, instead of going into the capital accounts of the recipient corporations, they were termed "dividends" and placed in the income accounts.

Despite the fact that Founders General Corporation, although a wholly owned subsidiary of American Founders Corporation, did not publish a financial statement, its accounts were not consolidated with those of its parent, American Founders Corporation, until May 1934.[12] Consequently, until that time, there was no disclosure in the financial reports of American Founders Corporation of the activities of its wholly owned subsidiary, Founders General Corporation; nor was there any other document where this information was made available to the investing public or to the general body of stockholders of American Founders Corporation.

In the financial statement of American Founders Corporation for the fiscal year 1929, total income for the period was reported as $13,483,719, of which $8,281,896 represented dividend and interest income.[13] Included in the item of "Income from Dividends and Interest," without segregation or identification of any kind, were the "dividends" of $4,961,750 received from Founders General Corpora-

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[8] Id., Commission's Exhibit No. X3896.

[9] The net profit of Founders General Corporation for 1929 was $7,592,782.16. In addition to the profits of $7,704,680.11 from dealings in United Founders Corporation stock and commissions of $916,770 additional, there was gross income of approximately $3,000,000 from other sources (id., Commission's Exhibit No. X3415), almost all of which was offset by special expenses, as will be shown in the discussion of Founders General Corporation's dealings in the stock of American Founders Corporation, infra. Royal E. T. Riggs, counsel to the Founders companies stated (id., at 2411) : "The greater portion of the dividends [paid out by Founders General Corporation] was probably made up of profits made upon the distribution of United Founders stock * * *."

[10] Id., Commission's Exhibit No. X3405-B.

[11] Dividends of $4,830,000 were received in 1929, by American Founders Corporation on its 20,000 shares of Class B common stock of Founders General Corporation (id., Commission's Exhibit No. X4273) which had cost it $550,000 (id., Commission's Exhibit No. X3415) ; and dividends of $131,750 were received on its 40,000 shares of preferred stock which had cost it $1,975,000 (id., Commission's Exhibit No. X3415). In addition, American Founders Corporation owned 10,000 shares Class A voting stock at a cost of $50,000, making its total investment up to October 17, 1929, $2,575,000. The return of American Founders Corporation on its entire investment in all classes of stock of Founders General Corporation in 1929 equaled 193%. (Id., Commission's Exhibit No. X3415.) On October 17, 1929, toward the close of the fiscal period, $3,000,000 was invested by American Founders Corporation in Class B stock and $2,000,000 additional in preferred stock of Founders General Corporation. (Ibid.)

[12] Id., Commission's Exhibit No. X3404-E11.

[13] Ibid., E-2.

tion, which comprised 60% of dividend and interest income, and 37% of gross income from all sources. This income, derived by American Founders Corporation from activities in the stock of United Founders Corporation, the company which controlled American Founders Corporation, in turn redounded to the advantage of United Founders Corporation in several respects. First, United Founders Corporation benefited, because of its substantial ownership of the common stock of American Founders Corporation, from the increase in the earned surplus accounts of American Founders Corporation and its subsidiary, Founders General Corporation. Secondly, United Founders Corporation benefited also from the enhancement in the market price of the American Founders Corporation stock resulting in some measure from the favorable earnings record.[14] Moreover, United Founders Corporation benefited even more tangibly when American Founders Corporation, early in 1930, partly because of its large receipts from Founders General Corporation, declared an extra cash dividend of 10% to stockholders of record as of January 15, 1930.[15] United Founders Corporation, which at that date already held more than 35% of the common stock of American Founders Corporation,[16] received approximately $1,000,000 out of the total distribution of $2,818,798.[17]

Early in 1930, United Founders Corporation increased its holdings of the common stock of American Founders Corporation to 78% of the total outstanding.[18] In that year, Founders General Corporation, the wholly owned subsidiary of American Founders Corporation, realized "profits" of $1,761,438 from dealings in the stock of United Founders Corporation.[19] Founders General Corporation passed on to American Founders Corporation in the form of dividends the sum of $1,379,950, which equaled approximately 27% of all dividend and interest income reported by American Founders Corporation for that period.[20] United Founders Corporation, by virtue of its 78% ownership of American Founders Corporation common stock, was an indirect beneficiary of these sums diverted into the income accounts of American Founders Corporation and its subsidiary from the money paid by the public for the capital shares of United Founders Corporation.

As was the case with the other forms of intra-group "profits" which were discussed in the previous sections, not only were these sums which were capital and not income placed in income accounts, but there was neither segregation nor explanation of any kind in the financial reports of American Founders Corporation or of United Founders Corporation with respect to these substantial sums included in income accounts.[21] Thus stockholders were not only kept in igno-

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[14] The market price of American Founders Corporation common stock rose from $84.63 a share in January 1929 to $122.87 in September 1929.

[15] Public Examination, American General Corporation, et al., Commission's Exhibit No. X4286.

[16] Id., Commission's Exhibit No. X3421–13.

[17] Id., Commission's Exhibit No. X4286.

[18] Id., Commission's Exhibit No. X3690 (p. 2).

[19] Id., Commission's Exhibit No. X3415, Schedules 20–A1 and 20–A2.

[20] Dividend and interest income for the period totaled $5,042,632. (Id., Commission's Exhibit No. X3405–"B.")

[21] Id., Commission's Exhibit No. X3404, E–2, E–3, and E–4.

rance that capital contributions were reported as income but they had no way of knowing how great a proportion of the dividend income account these sums constituted. Even if stockholders were not fully able to comprehend the true character of these "dividends," proper segregation might at least have enabled them to grasp the extraordinary and nonrecurrent character of these large amounts of "income" and to guard themselves against overestimating the normal earning power of their corporations. But lumped as it was in dividend and income accounts, there was nothing even to put stockholders on notice as to the existence of this "income."[22]

In extenuation of these practices, Royal E. T. Riggs, counsel to the Founders companies, stated:[23] "* * * when it came to the first report, that was the way it was handled by the accountants and we accepted it. I saw no reason for questioning their method of handling it." Mr. Riggs achnowledged, however, that "I think today there would be no question but that there would be an earmark or a footnote to indicate the amount of dividends received from Founders General as separate from dividends received from its general portfolio."[24]

a. Activities of Founders General Corporation in the Common Stock of Its Parent Company, American Founders Corporation

"Profits" of $253,937.94[25] and $1,030,703.75[26] were recorded by Founders General Corporation in 1928 and 1929, respectively, from distributing operations in the common stock of its parent company, American Founders Corporation. Concurrently with these distributing operations Founders General Corporation carried on market stabilization activities in American Founders Corporation common stock, in furtherance of which Founders General Corporation maintained a heavy "oversold"[27] position in this stock throughout the period under discussion until December 1, 1929.[28]

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[22] For example, in the report of American Founders Corporation for the 1929 fiscal period (id., Commission's Exhibit No. X3404, E–2), the first consolidated report of American Founders Corporation, it was not even specifically pointed out (except by the omission of Founders General Corporation from the list of subsidiaries consolidated) that the accounts of Founders General Corporation were not consolidated. Under the heading "subsidiaries" it was stated: "It [American Founders Corporation] owns all the outstanding stock of Founders General Corporation which specializes in the distribution of securities of investment companies, including those of the American Founders Group." It is evident that no indication was afforded by this language that Founders General Corporation for the 1929 fiscal period had earned $7,592,782 net, and had paid over to American Founders Corporation $4,961,750 as dividends.

Mention was made of the nonconsolidation of Founders General Corporation in American Founders Corporation's report for the fiscal period ended November 30, 1930 (id., Commission's Exhibit No. X3404, E–4, p. 8), but nothing was said to indicate whether the operations of that company had resulted in a loss or a profit.

[23] Id., at 24108.

[24] Id., at 24111.

[25] Public Examination, American General Corporation, et al., Commission's Exhibit No. X3732. The profits of $253,937.94 realized by Founders General Corporation in 1928 from

Footnotes 26, 27, and 28 on p. 2301.

The "profit" of $1,030,703.75 by Founders General Corporation in 1929 from transactions in the stock of American Founders Corporation [29] was the result of sales of 1,029,990 shares for aggregate proceeds of approximately $100,000,000.[30] The net profit of $1,030,703 from these sales would have been $528,256.16 greater, were it not for a loss of that amount recorded by Founders General Corporation when it finally closed out its oversold position in American Founders Corporation's common stock in November 1929.[31] At that date Founders General Corporation had an oversold position in this stock aggregating 46,778 shares, carried on its books at $94.70 a share, or a total of $4,430,211.39.[32] With the end of the 1929 fiscal period in sight (November 30), Founders General Corporation purchased from United Founders Corporation 46,778 shares of American Founders common stock needed to cover, paying therefor $106 a share. This established for Founders General Corporation a loss of approximately $11.30 a share, or $528,256, in the aggregate, on closing out its oversold position.[33] United Founders Corporation, which owned, as of November 30, 1929, 2,960,363 shares of American Founders Corporation common stock with a market value of $91,745,288,[34] obviously had a paramount interest in the continued firmness of the market price of American Founders Corporation stock; yet it was Founders General Corporation which was required to absorb the entire loss of $528,256 suffered in maintaining this market price. Moreover, by charging Founders Gen-

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sales of American Founders Corporation's common stock, are accounted for in the following schedule:

Period of sales	Number of shares sold	Realized profit	Average profit per share
1928:			
April through September—American Founders Trust common	43, 436	$125, 360. 96	[a] $2. 89
October through November—American Founders Corporation common (former shares split-up 2-for-1)	47, 043	128, 576. 98	2. 73
		253, 937. 94	

[a] The average profit per share would have been lower were it not for the sale of a block of 11,709 shares in August 1928 at a profit of more than $8 a share, or a total of $98,795. This "spread" was much higher than the average spread obtained previously or subsequent thereto.

[27] Id., Commission's Exhibit No. X3732. In 1930 there was a net loss of $4,615.44. (Ibid.)

[27] It was the contention of the Founders management that the term "short" position is not properly applicable to their case, in view of the fact that they always had an available source of supply at an established price for the shares sold in excess of their supply on hand at any given time. Without conceding the validity of this contention, use of the characterization "short" has been avoided, and the noncommittal term "oversold" has instead been employed in this report.

[28] The use of the continuous oversold position as part of Founders General Corporation's technique in "conditioning" the market action of the Founders stock is discussed, infra.

[29] Public Examination, American General Corporation, et al., Commission's Exhibit No. X3890.

[30] Id., Commission's Exhibit No. X3894.

[31] Id., Commission's Exhibit No. X3891.

[32] Id., Commission's Exhibits Nos. X3891 and X3894.

[33] Id., Commission's Exhibits Nos. X3891 and X3894.

[34] Id., Commission's Exhibit No. X3421.

eral Corporation the full market price of $106 a share for the stock, United Founders Corporation realized a profit on the sale of $29,329.80.[35]

Actually, Founders General Corporation did not end the period with an actual gain from its activities in the stock of American Founders Corporation. The net profit of $1,030,703 recorded by Founders General Corporation in the year 1929 from sales of American Founders Corporation stock, after deduction of the loss of $528,256.61 discussed immediately above, must be evaluated in the light of the fact that during 1929 Founders General Corporation paid out to dealers and salesmen as commissions and fees on sales of American Founders Corporation stock, a total of $1,379,938.12.[36] This sum was not charged to the investment profits account but was lumped in the total expense account of Founders General Corporation for the year 1929, while the profits of $1,030,703 were entered in the investment profit account. Consequently, although recorded on the books of Founders General Corporation, these sums did not cancel one another directly. It is evident that during 1929 Founders General Corporation sustained a net loss of $349,234.37 from its transactions in the stock of American Founders Corporation. On the other hand, as has been indicated, Founders General Corporation's activities in the common stock of United Founders Corporation did yield substantial sums which it treated as "profit" and from which it was able to pay large "dividends" to its parent, American Founders Corporation. Actually, however, it was merely passing on to American Founders portions of the money paid by the public for United Founders' stock and retained by Founders General.

b. Profits Recorded by Other Founders Companies From Sales to Founders General Corporation to Cover Its Oversold Position in American Founders Corporation Common Stock

Prior to the transactions, recounted above, in which Founders General Corporation turned to United Founders Corporation for a supply of American Founders Corporation stock to cover its oversold position,[37] there were several other occasions in 1929 when Founders General Corporation found it necessary to resort to its affiliates for the same purpose.

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[35] Id., Commission's Exhibit No. X3892. This transaction, among others set forth below, casts doubt on the management's contention that it merely "oversold" but did not sell "short." In this instance, it is apparent that Founders General Corporation did not have a ready source of supply at a previously fixed price, but was forced to procure the stock needed to cover by paying the full market price, in the same manner as any stock market trader; and in so doing it was forced, as was shown, to take a substantial loss, as the ordinary trader would have had to do.

[36] Id., Commission's Exhibit No. X3895. Founders General Corporation disposed of large amounts of American Founders Corporation stock through dealers with whom it had "open-end" selling agreements. To these dealers it paid commissions ranging from $2 to $3 a share, if the dealers placed the stock with a purchaser who held it for at least 60 days. One dollar of this commission was paid to the dealer at the time of the sale, and the balance was payable on proof that the purchase "stuck." (Id., Commission's Exhibits Nos. X4290 and X3895.)

[37] This transaction involved 46,778 shares of American Founders Corporation stock purchased by Founders General Corporation from United Founders Corporation at $106 a share.

In March and April 1929, United Founders Corporation purchased an aggregate of 47,129 shares of American Founders Corporation common stock at prices ranging from $83 to $86.75 a share. Immediately after making these acquisitions, United Founders Corporation sold the stock at prices ranging from $85.125 to $93.25 a share, thereby realizing a profit of $179,020.36.[38] As soon as the last sale was made, Founders General Corporation, on behalf of United Founders Corporation, began making purchases to replace the shares which had been sold. In May, Founders General Corporation turned over to United Founders Corporation 34,433 shares at an average price of $104.91 a share, and in June it turned over 15,301 shares at an average price of $100.56 each.[39]

In accumulating this stock, Founders General Corporation apparently made no profit,[40] but it promptly obtained a "loan" of these shares, along with others, from United Founders Corporation in order to make deliveries of American Founders Corporation stock in which it currently had a large oversold position.[41]

In October 1929, Founders General Corporation began to cover its oversold position in American Founders Corporation stock. In that month it purchased from United Founders Corporation a block of 60,000 shares paying $117 a share, the market price, for stock which had cost United Founders Corporation $106.024 a share, thereby giving United Founders Corporation a profit of $658,560.[42] In the same month, Founders General Corporation also purchased from Investment Trust Associates, at $116 a share, a block of 5,556 shares of American Founders Corporation stock which had cost Investment Trust Associates an average of $56.89 a share, or at a profit to Investment Trust Associates of $328,208.76.[43]

The final purchase by Founders General Corporation of 46,778 shares from United Founders Corporation in November 1929, to complete the closing out of its short position prior to the termination of the fiscal period on November 30, 1929, has previously been discussed, and the profit of $29,329.80 therein by United Founders Corporation was noted.

Thus, United Founders Corporation in the two sales of American Founders Corporation stock to Founders General Corporation, discussed above, realized aggregate profits of $687,889.80. Moreover, by virtue of the fact that United Founders Corporation owned at that date 45% of the common stock of Investment Trust Associates,[44] United Founders Corporation also benefited indirectly by the profit of $328,208.76 realized by Investment Trust Associates. Together, these profits, gained in aiding Founders General Corporation to carry out its market operations in American Founders Corporation stock, totaled $1,016,098.56—while Founders General Corporation at the same time, as has been shown, suffered a loss of $528,256.61, in the

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[38] Op. cit. supra, note 29, Commission's Exhibits Nos. X4288, X3892, and X3893.

[39] Id., Commission's Exhibit No. X4288. Whether an investment company which sells stock at $85 to $93 a share and replaces it immediately with shares of the very same kind at a cost of $100.56 to $104.91 may, with propriety, enter into income account a profit of $179,020 from its initial sale, is a question which is raised, but not discussed, at this point.

[40] Id., Commission's Exhibit No. X3894.

[41] Id., Commission's Exhibit No. X4288.

[42] Id., Commission's Exhibits Nos. X3892 and X3893.

[43] Id., Commission's Exhibit No. X3863.

[44] Id., Commission's Exhibit No. X3421 (Schedule 13).

purchase of 46,778 shares from United Founders Corporation, and a net loss in 1929 from such market operations of $349,234.37.[45]

c. Sums Entered in Income Account by Founders General Corporation on Sales of United Founders Corporation Common Stock

In 1929 Founders General Corporation entered in its income account the sum of $7,704,680.11, and in 1930, the sum of $2,405,512.49, from the sale of the common stock of United Founders Corporation.[46] In addition, Founders General Corporation derived other income from the same source in the form of commissions, which will be separately considered. The aggregate of the sums thus derived equaled $10,110,192.60 which is accounted for in the following schedule:

	"Profits" recorded
Fiscal year 1929:	
Recorded from sale of 108,063 shares at $21.424 of original issue of United Founders Corporation common stock acquired at $10.50[47]	$1,180,438.03
Retained from distribution of 2,400,000 United Founders Corporation common shares at a spread of 1 to 2 points[48]	3,850,000.00
Retained from trading and stabilization activities in United Founders Corporation common shares—1,969,144 shares sold[49]	2,674,242.08
Total. fiscal year 1929	7,704,680.11
Fiscal year 1930:	
Retained from trading and stabilization activities in common shares of United Founders Corporation—2,477,228 shares sold	2,405,512.49
Total, fiscal years 1929 and 1930	10,110,192.60

The first sum shown on this schedule, amounting to $1,180,438.03, was discussed in an earlier section.[50] It was shown to have resulted from an allotment to Founders General Corporation, in February 1929, of a block of 108,063 shares of United Founders Corporation stock at the "inside" price of $10.50 a share, which shares Founders General Corporation resold almost immediately at an average price of $21.424 a share or an aggregate "profit" of $1,180,438.03.[51]

During the year 1929, a total of 4,477,207 shares of common stock of United Founders Corporation was sold by Founders General Corporation for a total of $238,190,954.[52] These sales were of two kinds: sales by Founders General Corporation for the account of United Founders Corporation on a commission basis; and sales by Founders General Corporation for its own account. In the first category were 2,400,000 shares of United Founders Corporation common stock sold by Founders General Corporation as the agent of United Founders

[45] See supra; see also op. cit. supra, note 29, Commission's Exhibits Nos. X3892 and X3894.

[46] Op. cit. supra, note 29, Commission's Exhibit No. X3732.

[47] Id., Commission's Exhibit No. X3868.

[48] Id., Commission's Exhibit No. X3870.

[49] Id., Commission's Exhibit No. X4291.

[50] See supra, p. 2258.

[51] Ibid.; see also op. cit. supra, note 29, Commission's Exhibit No. X3868.

[52] Op. cit. supra, note 29, Commission's Exhibit No. X4291.

Corporation for a total of $121,944,941.[53] On these sales Founders General Corporation deducted commissions of one to two points, making a total of $3,850,000 received in commissions.[54]

The second category of sales comprises 2,077,207 shares sold by Founders General Corporation for its own account, for a total price of $116,266,013, and a net profit of $3,854,680.11.[55] Included among these 2,077,207 shares are the 108,063 shares discussed above,[56] allotted to Founders General Corporation at an inside price, on which Founders General Corporation recorded a "profit" of $1,180,438.03.[57]

The two categories of sales described above account for the 4,477,207 shares of United Founders common stock which, it has been stated, were sold by Founders General Corporation in 1929. The combined commissions and "profits" of Founders General Corporation on these sales equaled $7,704,680.11.[58] In the same year, Founders General Corporation received additional commissions totaling $916,770.37 for serving as agents in connection with transactions involving United Founders Corporation common stock.[59] These commissions

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[53] Id., Commission's Exhibit No. X3421, Exhibit A, Schedule 4 (plus $3,850,000 selling costs).

[54] The break-down of these commissions is set forth in the following schedule (Id., Commission's Exhibit No. X3870) :

Date of authorization of issue	Number of shares distributed by Founders General Corporation	Rate of compensation paid by United Founders Corporation to Founders General Corporation	Total commissions
March 9, 1929	500,000	1 point	$500,000
June 10, 1929	800,000	1½ points	1,200,000
July 17, 1929	100,000	1½ points	150,000
July 30, 1929	1,000,000	2 points	2,000,000
	2,400,000		3,850,000

As in the case of the American Founders Corporation stock described in the previous section, these commissions were entered by Founders General Corporation in its "realized profits accounts," on the theory that the sum remitted to United Founders Corporation constituted the purchase price to Founders General Corporation of the shares sold, and that the sum received on sale to the public constituted Founders General Corporation's selling price.

[55] Id., Commission's Exhibits Nos. X4291 and X3421, Exhibit A, Schedule 4.

[56] See supra, p. 2250.

[57] Op. cit. supra, note 29, Commission's Exhibit No. X3868.

[58] Id., Commission's Exhibit No. X3732.

[59] These commissions were comprised as follows:

1½ points upon the sale in July of 200,000 shares for the accounts of various Founders companies which exercised options to purchase at $41 a share. Sold at $54,063. Particulars furnished supra [a]	$300,000.00
Commission received in July at fifty cents a share upon 1,000,000 shares in connection with an offer by United Founders Corporation for the exchange of 1,000,000 common shares of United Founders Corporation for 500,000 common shares of American Founders Corporation. This exchange offer was made through Founders General Corporation to a selected group of dealers to approach shareholders to exchange their holdings at above ratio, these dealers receiving $2.50 for each United Founders Corporation share taken down, paid by United Founders Corporation [b]	500,000.00
Commissions received upon miscellaneous sales, 1929	116,770.37
Total	916,770.37

[a] See supra, p. 2252, and Public Examination, American General Corporation, et al., Commission's Exhibit No. X3861.

[b] Public Examination, American General Corporation, et al., Commission's Exhibit No. X3421, Schedule A–4.

of $916,770.37 increased to $8,621,450,[60] the total of the sums placed in its income account by Founders General Corporation from the proceeds of the sale of United Founders Corporation common stock to the public.

In 1930, Founders General Corporation bought and sold for its own account 2,477,228 shares of United Founders Corporation common stock for a total of $77,024,810, on which it realized net "profits" of $2,405,512.49.[61] In that year it also received commissions totaling $451,796.25 in connection with an exchange offer made by United Founders Corporation for the stock of American Founders Corporation.[62] However, Founders General Corporation in 1930 paid to dealers $879,031.01 as commission for stock sold by them.[63] Consequently, its net income from the distribution of United Founders Corporation common stock in 1930 equaled $1,978,277.73, and combined income for 1929 and 1930 totaled $10,599,727.[64]

Manifestly, if this $10,599,727 had been received directly by United Founders Corporation from the public it would necessarily have had to go into United Founders' capital account. By causing the distribution to be made by the wholly owned subsidiary of a corporation which United Founders controlled (and which during 1930, was itself a subsidiary 78% owned by United Founders) the $10,599,727 derived from the sale of United Founders stock was treated as profits, and passed back to American Founders Corporation and United Founders Corporation as dividends, thus window-dressing the income accounts of these corporations.

d. Oversold Position of Founders General Corporation in the Common Stock of United Founders Corporation—Nondisclosures Resulting from Failure to Consolidate Accounts of Founders General Corporation with Those of Its Parent Company, American Founders Corporation

It has been pointed out that although Founders General Corporation was a wholly owned subsidiary of American Founders Corporation, its accounts were neither integrated with those of its parent company in a consolidated statement until May 31, 1934, nor were they published independently.[65]

Whatever may have been the motives actuating the management of American Founders Corporation in this departure from established

[60] It will be recalled that in 1929 Founders General Corporation recorded a net profit of $7,592,783.16, and it was stated above that this net profit, from which substantial dividends were paid to American Founders Corporation, was derived mainly from dealings by Founders General Corporation in the shares of United Founders Corporation. The computations furnished above confirm that Founders General Corporation's income from dealings in United Founders Corporation common stock in 1929 totaled $8,621,450 which almost exclusively went to constitute net income, because, as was shown, the profit of $1,030,703 realized on the sale of American Founders Corporation stock in the same year was more than offset by commissions paid to dealers on account of such sales.

[61] Op. cit. supra, note 29, Commission's Exhibit No. X4291.

[62] Id., Commission's Exhibit No. X3897.

[63] Id., Commission's Exhibit No. X3895.

[64] $8,621,450 in 1929 and $1,978,277 in 1930. The figures set forth in the schedule at the beginning of this section represent only those items entered in "investment profits account" and do not include the commissions received, balanced against expenses. These have been included here and account for the difference of $489,535.

[65] In the report of American Founders Corporation to stockholders for the period ending November 30, 1930 (op. cit. supra, note 29, Commission's Exhibit No. X3404, E-4), the rea-

principles of accounting practice, it is certain that the direct and proximate effect of this departure was to conceal from the general body of stockholders and the investing public information of a material and significant character.

By virtue of the failure to consolidate, or at least to publish independently, the accounts of Founders General Corporation and American Founders Corporation, for example, the general body of stockholders of American Founders Corporation was kept in ignorance of the fact that in 1929 more than one-third the total dividend and interest income of their corporation was derived, as has been shown, from dealings in the common stock of the company which controlled it, United Founders Corporation.[66] Consolidation of the accounts of American Founders Corporation and Founders General Corporation would have resulted in the complete elimination from the consolidated statement of the $4,961,750 of "dividends" received in 1929 by American Founders Corporation from Founders General Corporation.[67] Instead, the consolidated income account would have been increased by the amount of Founders General Corporation's income, which income would have been clearly identified in the form of consolidated statement employed by American Founders Corporation in 1929,[68] so that the reader of the report could not have failed to note the extraordinary nature and disproportionate amount of this income as compared with total income of the consolidated system.

The failure to consolidate also gave rise to opportunities for "window dressing" the portfolio of American Founders Corporation prior to publication, by transferring to Founders General Corporation, whose portfolio was not published, securities of an unattractive character, and receiving in exchange securities which would better lend themselves to public scrutiny.[69]

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son for not consolidating was stated as follows: "Subsidiaries not consolidated—American Founders Corporation owns all the preferred and Class B stock of Founders General Corporation, a security distributing company, and all the stock of American Founders Office Building, Inc., which owns the property of 50 Pine Street, New York. Inasmuch as their business differs from American Founders Corporation and as the investment in each of them is small in proportion to the resources of American Founders Corporation, their accounts have not been consolidated." Nothing was said as to the reasons why independent statements for these companies were not published, thus supplementing and completing the consolidated report.

Subsequently, in announcing the consolidation of the accounts of Founders General Corporation with those of American Founders Corporation for the six-month period ended May 31, 1934, it was stated "In accordance with recent trends in accounting practice the accounts of Founders Feneral Corporation and of American Founders Building, Inc., wholly owned subsidiaries, are consolidated in the financial statements accompanying this report."

[66] See discussion in earlier sections of this chapter.

[67] For a discussion of accepted accounting practice in the preparation of consolidated statements, see Kohler, E. L., "Some Tentative Propositions Underlying Consolidated Reports," Accounting Review, Vol. 13, March 1938, p. 63 et seq.

[68] In the 1929 report of American Founders Corporation (op. cit. supra, note 29, Commission's Exhibit No. X3404–E2), the accounts of each of the companies integrated in the statement were separately set forth, and then totaled.

[69] For example, in November 1930, American Founders Corporation delivered to Founders General Corporation a lot of securities having a cost value of $4,427,707 and a market value of $2,052,492, in exchange for 315,768 common shares of United States Electric Power Corporation common stock having the same market value. (Id., Commission's Exhibit No. X4274.) American Founders Corporation entered the securities received on the exchange from Founders General Corporation at the cost of the securities transferred, that is $4,427,707. (Id., at 26550.) Hereafter it will be shown that this was an accounting device frequently employed by the Founders management to avoid reporting losses to stockholders, while at the same time permitting the companies to claim losses in their income-tax returns. (See infra, p. 2340.)

Furthermore, the failure to consolidate the accounts of Founders General Corporation with American Founders Corporation made possible concealment of another highly significant situation—the heavily oversold position of Founders General Corporation in the common stock of United Founders Corporation. This oversold position reached a month-end peak on August 31, 1929, when it equaled 409,761 shares carried on the books at $26,239,003.[70] At the fiscal year's end—November 30, 1929—the oversold position was 102,719 shares, carried at $4,369,089;[71] and a year later, November 30, 1930, the oversold position was 216,930 shares carried in the books at $2,077,054.[72] Had the accounts of Founders General Corporation been consolidated with those of American Founders Corporation, the oversold position existing at the year ending November 30, 1929, would have been revealed in the American Founders Corporation's consolidated statement for that period.

Commencing with May 31, 1930, United Founders Corporation published a consolidated statement which included the accounts of American Founders Corporation and which would therefore also have embraced the accounts of Founders General Corporation if the latter's accounts were consolidated with those of its parent, American Founders Corporation. By avoiding consolidation, the Founders Group management avoided disclosure, with the result that the general body of stockholders and the investing public were kept in ignorance of the substantial short positions extant in the stock of United Founders Corporation throughout 1929 and 1930, and the huge liability resulting therefrom in the accounts of Founders General Corporation and consequently in those of its parent, American Founders Corporation.

The continuous oversold position of Founders General Corporation in the common stock of United Founders Corporation[73] (and, simi-

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[70] Op. cit. supra, note 29, Commission's Exhibit No. X3790.

[71] Id., Commission's Exhibit No. X3415 (Portfolio). This was the oversold balance carried at $42.53438 a share in an account entitled "Investments—United Founders Corporation—Common Stock—Trading Account." However, at this fiscal year end, November 30, 1929, there was also a long position of 5,000 shares carried at $26 a share, totaling $130,000, which shares were acquired in November 1929 and were carried in an account entitled "United Founders Corporation—Special Investment Account—'W. R. B'." This lot was disposed of in January 1930 at $26.25 a share for a profit of $1,250, which sum was credited to the investment profits account of Founders General Corporation. Also at the fiscal year end November 30, 1929, there was a long position of 55,681 common shares of United Founders Corporation carried at $42.01623 a share, total $2,360,871.48, in an account entitled "Investments—United Founders Corporation—Common Stock—Special Account ("C" Account)," which shares were a remainder of acquisitions during November 1929. In February 1930, the balance then appearing in the account of 53,085 shares, at $52.60 a share, totaling $2,792,295, was transferred to "Trading Account." (Derived from supplementary information supplied the Commission for Founders General Corporation.)

[72] Op. cit. supra, note 29, Commission's Exhibit No. X3415 (Portfolio).

[73] Mr. Seagrave testified (id., at 24692 et seq.):

"Q. Mr. Seagrave, Exhibits 3790 and 3711 show that the oversold position of Founders General [in the common stock of United Founders Corporation] was $3,000,000 in May of 1929, $16,000,000 in June of 1929, $21,000,000 in July, and $26,000,000 in August, and in shares it ran from 89,000 shares in May to 409,000 shares in August. Those figures you have no question about?

"A. No. May I ask whether those figures are for the month-end?

"Q. Yes.

"A. Well, there is an observation I think might be of some consequence on those, and that is that those happened to be the oversold positions at particular dates or month ends. I think, as a matter of fact, during one or two of the months they, for a day or two, were actually higher than those figures, but the practice in the early part of the summer, when

larly, to some extent in the stock of American Founders Corporation) was attributed by Louis H. Seagrave to the exigencies of the endless selling campaign which was the crux of the Founders distributing technique. This perpetual selling program was beset with evils which Mr. Seagrave acknowledged were inherent in such a technique, and which caused him to state that "I would not adopt it today as a method for financing a company of this type." Mr. Seagrave testified:[74]

Q. So at that time you think it was customary, Mr. Seagrave, for a concern that was in the process of issuing securities from time to time, to keep a continuous oversold position?

A. Well, I am pretty sure it was; yes. I think it was a very usual custom, but, on the other hand, it was only a usual custom in connection with concerns that did that, and that was not the commonest way of issuing securities; in other words, the orthodox method of issuing securities to issue that many and finish that job and perhaps no more will be issued for a long time to come. This was a continuous selling program practically throughout that year.

Q. You think, then, the case of a concern managing investment trusts and continuing to sell its own securities from time to time, that in itself was not a common practice? You have no particular analogy for that, have you?

A. I do not want to be quibbling, but I think I ought to sit straight in my answer to part of your question.

Mr. Seagrave testified that the distribution technique of the Founders Group was similar to that employed by The North American Company and Cities Service Company, utility holding companies:[75]

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there was less stock outstanding, was when the oversold position ran substantially above 150,000 shares to take down 50,000 or 100,000, as the case might be. Later on, in August, when I think there were some 6,000,000 shares outstanding, we increased that to 200,000 shares, and as it ran up above, some days it ran up pretty rapidly. In other words, the dates when the oversold position remained substantially above 200,000, up to August, there were only a few, there was merely that delay during which some mechanical detail of taking down the shares that were originally issued could be carried out.

"Mr. Riggs [of counsel to the Founders companies]. I would like to ask Mr. Seagrave if he has any data before him from which he can testify as to what the percentage of the oversold position of shares was to the total outstanding shares?

"The Witness. This memorandum, prepared in our office from the records, shows that at the month ends from April to December in 1929 there were certain oversold positions which include the very figures you have given for certain months. It also shows the shares outstanding at the same month ends, and shows that on April 30th the percentage of outstanding shares was 1.29 percent; May 31st, 3.35; June 30th, 7.54; July 31st, 7.50; August 31st, 7.66; September 30th, 4.06; October 31st, 2.73; November 30th, .70, and in December a slight long position.

* * * * * * *

"Q. So during 1929 the highest oversold position was 7.66 percent of the outstanding stock, at the end of August 1929?

"A. That is right. That is the highest percentage given.

"Q. Now is it usual and customary, in the distribution of securities, to have a moderate oversold position, say not exceeding 10 percent?

"A. I think the customs vary, and I think the custom even in those days varied, depending a good deal on the issue. I think, in general, that an oversold position on equity securities at the go-off of up to 10 percent was quite common. On bonds it was usually not as large as that, and ordinarily, after the early and the secondary distribution had been finished it was common for those percentages to be reduced, but in this particular case we were continuing distribution throughout that period, and yet the ratios that actually existed day by day were substantially below the 7.50, because we were taking down and bringing it back to close around 5 percent whenever we got materially above that."

[74] Id., at 24695 et seq.

[75] Ibid.

A. United Founders was doing most of the capital raising during that year. United Founders was not managing the subsidiaries. American Founders were managing certain affiliated companies in which it had a very substantial interest. I can only say we were not unique in that respect. There were other selling programs which went on continuously. I have in mind particularly The North American Company, and another company which escapes my tongue for the moment, but a large public-utility company.

Q. Did they have their own distributing concerns too?

A. Yes; I think in both cases they were part of the organization.

Mr. RIGGS: The Cities Service?

The WITNESS: The Cities Service was the company, I think.

When examined upon the advisability of this method of distribution, Mr. Seagrave testified:[76]

Q. Apart from what other concerns may have done, or from what was customary, do you think now that this is a good and advisable technique?

A. No; I would not adopt it today as a method for financing a company of this type. I think it may be an advisable technique as applied to mutual companies so-called in the investment field, who customarily sell their securities at the asset value.

Q. You mean like open-end trusts?

A. Yes; so-called mutual companies.

Mr. RIGGS: You asked about the technique. Do you mean the technique of the oversold position or technique of continuous selling for the combination?

Mr. STERN: The technique of the combination, the oversold position and continuous selling.

The WITNESS: My answer was directed to the continuous selling, Mr. Stern. As to the advisability of an oversold position I think it is usually advisable. The size, certainly, should not be exorbitant, but there are, and I am afraid will continue to be, in the investment field chiseling dealers and chiseling clients, who, until their activities are cleaned up, will necessitate the maintenance of a secondary buying power. Some companies, of course, will succeed in financing, largely sales of institutions, without any need of it, and others I really think do need some modest oversold position to help to clean up that type of purchasing.

Q. Mr. Seagrave, what is your objection to a continuous selling in an investment concern like this?

A. Well, I have one profound objection, and one which I think practically at all times throughout this period from 1925 to 1932 we would have liked to get rid of, and that is the time and attention that officers and directors, and the staff, have to give to selling to keep themselves before the public when, I think it would be far better for them to confine themselves to the operation of the trust without any thought once they raised the capital. I think there is a possibility for some abuses in a continuous-selling program, but a continuous-selling program of this type probably would not work, excepting in a general market which was rising, in other words, after so much had been taken. If you find a dull appetite for further issues and it was depressed the result would probably be it would knock the market down. In other words, one great difficulty—and this is not a matter of policy, but it is a practical difficulty—by continuous selling is you have the load of yesterday's sales as an additional threat to the market today, and every additional share you sell creates an additional broad selling power which may suddenly come

[76] Ibid.

in to threaten your markets, and if it does, of course you are selling stocks. Whereas, a job that is done in a day or a week, or a few weeks, and completed does not thereafter have to carry on that particular burden. The market seeks its level, finds it, and presumably the company goes on about its affairs.

Q. Mr. Seagrave, following up your statement before, this continuous-selling business not only has the difficulty that the minds and attention of the executives may be devoted to that rather than the problems of investment, but it also means, does it not, that where you have an organization that has to handle distribution, you have got to furnish them with distribution to keep them busy * * *.

A. That is true. You cannot build up a large, able, and experienced organization and then quit selling, you have got to find something for them to sell.

Q. So that, in a sense, there is a kind of what we might call a vicious circle in that. Not only does it take up the time of the executive from the investment problems, but on the other hand, in order for that department to function it must constantly require new distribution, which again requires it to take their minds off the question of investment?

A. Yes; I think that is true. Of course, the answer to it is there ought to be a time when you can taper off, reduce your organization, and eventually discontinue selling. During the time you continue it that certainly is one of the problems.

Thomas H. Benton, vice president of Founders General Corporation, confirmed in his testimony that the continuous oversold position of Founders General Corporation in stocks of the top Founders company was an important element in Founders General Corporation's market operations technique:[77]

Q. Now, coming back to this oversold position, you recall that at all times that was very large and continued for several months at a time?

A. Yes.

Q. And do you remember how large the oversold position in United Founders was?

A. Not at any particular time.

Q. Do you remember that that got to be as large as $20,000,000?

A. I don't recall what it would amount to in dollars; I wouldn't recall how much it was in dollars.

Q. It got to be as high as $20,000,000, that oversold position in United Founders.

Mr. Aal. That is right.

By Mr. Stern:

Q. Now, I think you testified, and see if I am not correct in understanding you to say, that the oversold position gave Founders General a very substantial advantage in trading, that is that you had two sources of supply—you could go either to the company—

A. (interposing). Or in the open market; yes, sir.

Q. And that oversold position was pretty generally known to exist, was it not?

A. Quite generally known.

Q. And that also had the tendency to hold any person who was likely to be obstreperous, in line, did it not?

A. Well, I would like to change that because I just can't recall whether it was quite generally known or not, but it was known by some people.

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[77] Id., at 24544–6.

Q. Well, if it was known by some people, it would be known by the key dealers, would it not?

A. Some of them, probably.

Q. And that would have a tendency to keep the market from running away from you?

A. Yes; I think so.

The evils inherent in the perpetual selling program of Founders General Corporation; the continuous heavily oversold position of Founders General Corporation in the securities of the top Founders companies and the opportunities presented thereby to manipulate the market; the large profits gained by Founders General Corporation from dealings in the securities of these companies; the "upstream" passage of these profits back to the companies which issued the securities; and the "window dressing" of reports by shifting of undesirable securities were all practices effectively blanketed from public view by reason of the failure on the part of the Founders management to consolidate the accounts of Founders General Corporation with its parent, American Founders Corporation, or to publish independent financial statements applicable to Founders General Corporation. It will be recalled that Royal E. T. Riggs, counsel to the Founders companies, in a statement previously set forth, avowed, "I think today there would be no question but what there would be an earmark or a footnote to indicate the amount of dividends received from Founders General Corporation as separate from the dividends received from its general portfolio."[78] It was inferred by Mr. Riggs that the initiative in the practice of nondisclosure was taken by the Founders' accountants: "When it came to the first report, that was the way it was handled by the accountants and we accepted it. I saw no reason for questioning their method of handling it."[79]

W. H. Conkling, member of the accounting firm of Loomis, Suffern & Fernald, which served American Founders Corporation as consulting accountants in 1929, and as auditors in 1930, defended the nonconsolidation of the accounts of Founders General Corporation with its parent company and the nondisclosures which resulted thereby. It will be observed that in Mr. Conkling's testimony on this subject, which is set forth below, there is evidenced the same complete disregard of substance in favor of mere form as was previously displayed in Mr. Conkling's defense of the transfer of Investment Trust Associates stock through the medium of D. H. Silberberg & Company in order to circumvent the necessity for eliminating from the consolidated statement the intercompany profit gained on that sale.[80] Mr. Conkling's testimony follows in part:[81]

Q. Now do you remember the case of the Founders General Corporation? Do you remember that was a wholly owned subsidiary of American Founders?

A. Yes, sir.

Q. That was not consolidated in the report of American Founders. Why?

A. We felt that they were in a different kind of business and it would make

[78] Id., at 24111.

[79] Id., at 24108.

[80] See supra, p. 2280.

[81] Op. cit. supra, note 29, at 26730 et seq.

a much more complicated report and we felt even if they did consolidate Founders General it would probably not be any material difference in the results, but, primarily because they were in a different type of business, marketing securities, and the effort was to show the results from the standpoint of the investment trust and investment company.

By Mr. RIGGS:

Q. It was stated in the reports themselves in each instance Founders General was not consolidated for that reason, wasn't it?

A. Yes, sir.

By Mr. STERN:

Q. I have no doubt it was stated for that reason. Founders General was not selling. But did the report show that Founders General, for example, made profits on the sale of American Founders stock, the stock of its principal, its parent?

A. The report of the United Founders?

Q. No; American Founders.

A. The answer is "No."

Q. Do you think that is a sound thing?

A. I think there was nothing wrong in that.

Q. Well, do I understand you correctly, Mr. Conkling, to assert that it is all right for American Founders to trade in its own shares?

A. No; I think that American Founders should not generally trade in their own shares.

Q. And that especially goes for common shares?

A. Yes, sir.

Q. But it is all right for the wholly owned subsidiary to trade in the shares and not be consolidated?

A. Yes; I think they had a right to have a wholly owned subsidiary whose business it was to trade in shares.

Q. And that it would be all right for the American Founders to show the dividends received from that subsidiary from trading in the parent's shares. And it would be all right to have the report to show that those dividends came from what was in effect the parent company trading in its own shares?

A. I think the profits, the dividends which came from Founders General, which resulted from trading in shares of the companies of this group were legitimate profits.

Q. So that the indirect method is as far as you, an accountant, is concerned, although it accomplishes the same result, which would be unfortunate if done directly, is all right?

A. I think in this case it was justified; yes, sir.

Q. Now bear in mind, Mr. Conkling, that we were not dealing with the subsidiary merely, we were dealing with the wholly owned subsidiary, every bit of which was owned by the American Founders, and your answer still remains the same?

A. Yes, sir.

Q. And, therefore, assuming that it is perfectly legitimate to make those profits, do you think it is all right when you show the dividends received from those profits not to make any explanation about those dividends?

A. I think so. We are assuming that the case is exactly similar to this situation here.

Q. So that we don't have any qualifications of that, let us take the case where the wholly owned subsidiary deals in the securities of the parent or the

grandparent as it also did, makes profits from this [dealing], turns those profits into dividends and passes the dividends back to the parent company, you think first it is all right not to consolidate, and secondly, that it is entirely satisfactory not to show that these profits came from that kind of transaction?

A. Yes, sir.

4. FAILURE TO SEGREGATE AND REVEAL SUMS RECORDED AS INCOME BY FOUNDERS COMPANIES FROM TRANSACTIONS IN THE SECURITIES OF UNITED STATES ELECTRIC POWER CORPORATION

United States Electric Power Corporation was a large public utility holding company formed on September 10, 1929, on the eve of the market collapse (October 29, 1929). It was sponsored by the Founders Group in conjunction with various banking interests which were seeking to obtain a position of influence in the billion dollar utility system headed by Standard Gas and Electric Company, under the control of H. M. Byllesby & Company.[1]

The initial issue of stock of United States Electric Power Corporation consisted of 2,000,000 shares of Class A stock, 1,100,000 shares of common stock, and 5,110,000 warrants to buy one common share at $25 a share up to January 2, 1940.[2]

On September 10, 1929, United Founders Corporation and American Founders Corporation subscribed to 700,000 Class A shares at $10 a share and 350,000 shares of common stock at $13.50 a share, for a total of $11,725,000.[3] This price was paid by delivering to United States Electric Power Corporation, pursuant to agreement, 61,710 shares of Standard Gas and Electric Company common stock at a price of approximately $190 a share.[4] This transaction will be discussed in a subsequent section of the present chapter.[5]

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[1] The principals in the movement to obtain a controlling interest in Standard Gas and Electric Company were Victor Emanuel of the brokerage and banking firm of Emanuel & Co., and interests associated with the Belgian financier, Alfred Loewenstein. Mr. Emanuel was associated in the formation of United States Electric Power Corporation through a company named Union Electric Power Corporation; the Loewenstein interests were represented by a company called Hydro-Electric Securities Corporation.

In addition to the Founders Group and the Loewenstein and Emanuel interests, the following interests were also associated in the organization of United States Electric Power Corporation: The Harris Forbes Corporation, W. C. Langley & Co., Arthur C. Allyn, Thomas A. O'Hara, and Seaboard National Corporation. For the bankers, one of the benefits expected was participation in the banking business of the Standard system. A contract was subsequently entered into by the banking interests allotting the participations in underwriting Standard Gas and Electric Company issues. The detailed account of the formation and history of United States Electric Power Corporation is set forth in Pt. Four of the overall report on investment trusts and investment companies.

[2] Total authorized capital stock consisted of 1,000,000 shares preferred, and 2,000,000 shares Class A, 20,000,000 shares common, all without par value. (Poor's, *Public Utilities*, 1930.)

The corporation's charter provided that Class A stock as a class and common stock as a class were entitled to equal voting power. Two million warrants were "detached" warrants and were given with the 2,000,000 Class A shares; the other 3,100,000 warrants were non-detachable warrants attached to the Class A. (Public Examination, American General Corporation et al., Commission's Exhibit No. X4018.)

[3] Public Examination, American General Corporation et al., Commission's Exhibit No. X3904.

[4] Ibid.

[5] See infra, p. 2327.

On the same day, United Founders Corporation agreed to purchase for cash not less than 1,100,000 nor more than 1,250,000 shares of United States Electric Power Corporation common stock, at $13.50 a share, for the purpose of offering these shares to the stockholders of United Founders Corporation in the form of "rights" to subscribe.[6] American Founders Corporation simultaneously agreed to purchase between 900,000 shares and 1,100,000 shares at $13.50 a share, which it offered to its stockholders in the form of "rights" to subscribe.[7] Pursuant to these agreements the two Founders companies took down a total of 2,278,340 shares of common stock, of which 1,748,079 were passed on to their stockholders who exercised the rights issued to them.[8] In this manner the Founders companies not only absorbed substantial blocks of United States Electric Power Corporation stock on their own account but, in addition, they effectively tapped the reservoir of buying power represented by their large bodies of stockholders.

a. Nondisclosure of Transfers Within the Group of United States Electric Power Corporation Stock at Prices Below Market

United Founders Corporation issued to its stockholders, as of September 14, 1929, "rights" to subscribe on or before October 15, 1929, to one share of United States Electric Power Corporation common stock at $15 a share on the basis of one share of United States Electric Power Corporation common for each five shares of United Founders Corporation. American Founders Corporation issued to its stockholders similar rights on the basis of one share of United States Electric Power Corporation common for each two and one-half shares of American Founders Corporation.[9]

By agreement between the sponsors of United States Electric Power Corporation, Founders General Corporation had been vested with the functions of distributing United States Electric Power Corporation's common stock to the public and of making a continuous market for this stock.[10] As a result of sales restriction agreements on the part of these initial subscribers of United States Electric Corporation's stock,[11] Founders General Corporation enjoyed almost exclusive control of the available supply of the common stock and was able at once to maneuver the market price to high levels.

Announcement of the formation of United States Electric Power Corporation was made on September 11, 1929.[12] Commencing on September 12, 1929, Founders General Corporation, without awaiting issuance of stock to it by United States Electric Power Corporation, or even official authorization thereof, began to trade the stock over-

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[6] Op. cit. supra, note 3, Commission's Exhibit No. X3900.

[7] Id., Commission's Exhibit No. X3899.

[8] Id., Commission's Exhibits Nos. X3901 and X3422 (A–4, B–2).

[9] Id., Commission's Exhibits Nos. X3899 and X3900.

[10] Id., Commission's Exhibits Nos. X4025 and X4031.

[11] The sponsors had entered into sales restriction agreements with respect to the stock received by them from the original issue, which insured that the stock would not come into the market in such fashion as to hamper Founders General Corporation in its distribution and market activities. (Id., Commission's Exhibit No. X4025.)

[12] Id., Commission's Exhibit No. X4022.

the-counter on a "when-as-if" basis at prices of more than $30.00 a share.[13]

In the course of supplying United States Electric Power Corporation common stock to its stockholders on the exercise of the rights issued to them, American Founders Corporation found that it required 24,753 shares more than the 990,000 shares which it had taken down pursuant to the agreement of September 10, 1929.[14] Although the market price had, as was stated, advanced to approximately $30.00 a share,[15] United Founders Corporation supplied to American Founders Corporation the 24,753 shares needed by it at the original issue price of $13.50 a share, or a total of more than $408,000 under the market price.[16]

Louis H. Seagrave, president of United Founders Corporation and of American Founders Corporation, and Lawrence P. Carron, treasurer, explained this transaction in the following manner: [17]

Q. What happened, Mr. Carron?

A. (Mr. CARRON) What happened was that United Founders Corporation had taken down more shares than it needed for the sale to the stockholders under rights. American Founders had taken down less. Toward the end it became evident that a number of stockholders of United Founders were not exercising their rights. United Founders, even with the number of shares it had taken down, had more than it needed for the sale to the stockholders. American Founders required about 24,000 shares more. As between the two companies, they felt American Founders could make up the shortage by merely transferring the shares to United Founders, considering both as one. It was not a sale; it was merely a transfer of the take-down of 24,000 shares between the American and United Founders at the original price.

Q. But they were different corporations with different stockholders, Mr. Carron.

A. (Mr. SEAGRAVE) May I observe as to the principle of this thing which was undoubtedly the point back to which Mr. Carron went in arriving at that conclusion, United States Electric Power Corporation authorized a certain amount of shares for a certain purpose.

It was the best guess we could make of the amount needed for that purpose. As it happened, it was more for United Founders and less for American Founders than we needed. If we had been able to calculate the exact number of shares required at the time the United States Electric Power authorized the issuance it would have been calculated down to the last share. It happened there was an over-estimate of the requirements of United Founders and an under-estimate of the requirements of American.

Q. But United Founders took down the shares and paid for them, and they could keep them. They are under no obligation to return those shares?

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[13] Id., Commission's Exhibit No. X4099. Since the only assets of United States Electric Power Corporation at this time consisted of 183,414 shares of Standard Gas and Electric Corporation common stock with a market price at the time of approximately $195 a share (id., Commission's Exhibit No. X3422), the price of more than $30 a share for United States Electric Power Corporation common was tantamount to according a value of over $500 a share to the United States Electric Power Corporation holdings of Standard Gas and Electric Company stock. (See Pt. Four of the over-all report.)

[14] Op. cit. supra, note 3, at 26786, et seq.

[15] Ibid.

[16] Id., Commission's Exhibit No. X4294. It will be recalled that in September 1929, when this stock was transferred at a price more than $408,000 under the market value, United Founders Corporation owned not in excess of 35% of the common stock of American Founders Corporation. (Id., Commission's Exhibit No. X3421, Schedule 13.)

[17] Id., at 26355 et seq.

A. Well, there was no legal obligation. I think there was a moral obligation to United States Electric Power.

* * * * * * *

Q. A gift was made to American Founders of some $350,000 in value because you thought you morally should do it?

A. I stated I didn't even know about it at the time, but I am disposed to defend it, because I believe it was really the carrying out of the essence of the understanding with United States Power.

The published reports of the companies contained no mention whatever of this transaction.[18] Allan H. Clarke of the firm of Clarke, Oakes & Greenwood, accountants who certified these reports,[19] testified:[20]

Q. To what extent are intercompany transactions suspect? I mean, where one company sells to another; to what extent do you look into them and give them special attention?

A. Well, I would say in all instances we would look into intercompany transactions.

Q. And then, if you find there is a sale of securities that have a market value, do you check up in the market?

A. I would; yes; where the sum was material. There might be an interchange of small lots, blocks, one thing and another.

Q. And where there is a material transaction?

A. I would certainly say so; yes.

Q. And the transaction in which there was a $350,000 discrepancy between market and purchase price, that would be a material transaction, wouldn't it?

A. Depending on the volume, on the amount of the stock and the amount of the transaction. It might be relatively immaterial, depending on the volume of the stock.

Q. Well, United Founders sells to American Founders a certain number of shares in one block that has a differential between the purchase price and the market value of $350,000. There can be no doubt that that is a material transaction?

A. Well, it might have been a $35,000,000 transaction, in which they may have asked one percent. I think I can answer that question, that ascertaining the facts, and provided the management couldn't give us a satisfactory explanation, we would probably try to prevail on them to change, to perhaps bring about a cure of the transaction. Otherwise they would have to satisfy us that it was a perfectly honest transaction. Now, if there was any doubt in our minds, the management would be perfectly—under most circumstances, if they were sincere and honest—be perfectly willing to allow the accountant to make a reference in his statement to what had transpired.

Q. Well, the transaction that we are referring to here, some 24,753 shares, was sold by United Founders to American Founders at $13.50 per share. It happened that the market value was $30, and that accordingly the differential was in excess of the purchase price—the differential was $408,000. The purchase price was around $350,000.

* * * * * * *

There could be no question on that that was a material transaction?

A. Was a material transaction.

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[18] Id., Commission's Exhibits Nos. X3404 and X3420.

[19] Id., Commission's Exhibit No. X3420, E–2.

[20] Id., at 26782 et seq.

Q. And being a material transaction, what would you do about it?

A. Well, I think my answer to that is the same as it has been in a great many other instances here. We would think twice before not making any reference to the fact in the statement. Undoubtedly at that time we were satisfied there was a quid pro quo somewhere, that the transaction was in the interest of the stockholders, and perfectly satisfied. I must have been satisfied at that time. I don't recall. I haven't heard of the item for eight years now. I can't recall the circumstances or conversations concerning it. I undoubtedly knew all about it, knew all the facts.

Q. Mr. Clarke, the explanation given for it was that it was intended that United Founders should take down only the number of shares from U. S. E. P. that was needed to cover the rights that they were issuing to stockholders, and that they took down more than they needed, and American Founders took down less than they needed. Now, assuming that explanation, would you think that that would be a sufficient explanation to warrant you in not giving that item some special treatment in your report?

A. Well, putting it that way, I would say on its face that it would call for some special explanation, but I say that I make that statement with a reservation of being entirely familiar with the transaction at the time, and a great many of the circumstances connected with that transaction, and explanations of the officers of the company and what not. Obviously at that time we didn't consider it necessary to make any reference to it in our certificate.

As a result of the exercise of rights issued to their stockholders, American Founders Corporation distributed a total of 1,014,753 shares of common stock of United States Electric Power Corporation at $15 a share [21] and United Founders Corporation distributed a total of 733,326 shares.[22] Since these shares had cost the two Founders companies $13.50 each, there was a gross profit of $1.50 a share, or a total gross profit of $1,522,129.50 for American Founders Corporation and $1,099,989 for United Founders Corporation. Expenses reduced the net profit of American Founders Corporation to $1,181,259.56 [23] and that of United Founders Corporation to $600,573.57.[24]

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[21] Id., Commission's Exhibit No. X3901.

[22] Id., Commission's Exhibit No. X4294. United Founders Corporation, as has been stated, actually purchased 1,288,340 shares of United States Electric Power Corporation common stock for distribution to its stockholders, and after distributing the 733,326 shares to its stockholders and transferring 24,753 shares to American Founders Corporation as described above, it retained a balance of 530,261 shares in its investment account. (Ibid.)

[23] Id., Commission's Exhibit No. X3901:

Gross profit, 1½ points upon 1,014,753 shares		$1, 522, 129. 50
Less:		
Transfer taxes	$60, 756. 90	
Miscellaneous expenses	100, 084. 04	
Commissions to Founders General Corporation at 50¢ a share upon 360,058 shares taken down through it	180, 029. 00	
		340, 869. 94
Net profit		1, 181, 259. 56

[24] Id., Commission's Exhibit No. X4294:

Gross profit, 1½ points upon 733,326 shares		$1, 099, 989. 00
Less expenses:		
Commissions	$301, 585. 00	
Transfer tax	43, 470. 18	
Transfer agent fee	76, 879. 78	
Fee to Equitable Trust	77, 480. 47	
Total expense		499, 415. 43
Net profit		600, 573. 57

More than one-half of American Founders Corporation's net profit of $1,181,259 was the result of the exercise by United Founders Corporation of the rights received in its capacity of stockholder of American Founders Corporation, supplemented by purchases from American Founders Corporation.[25]

Although these profits which aggreated $1,781,833.13 resulted from transactions between these companies and their stockholders and therefore possessed an unusual and nonrecurrent character, neither the net profit of $1,181,259 realized by American Founders Corporation[26] (of which 59% was the result of intercompany transactions) nor the net profit of $600,573 realized by United Founders Corporation, were in any manner segregated or identified in the respective published financial reports of these companies,[27] but were lumped in the category entitled "Profits upon the Sale of Investments."[28]

b. Nondisclosure of Additional Sum of $5,619,384 Recorded as Income by United Founders Corporation in Connection with United States Electric Power Corporation Rights

The pecuniary benefits derived by the Founders companies from the distribution of "rights" to their stockholders for the purchase of United States Electric Power Corporation stock were not confined to the $1,781,833 net profit discussed in the preceding section. An additional $5,619,384 was recorded in the "Dividend Income Account" of United Founders Corporation by the execution of a simple maneuver which took the following form.

United Founders Corporation as a stockholder of American Founders Corporation received 936,564 "rights" entitling it to purchase 374,625 shares of common stock of United States Electric Power Corporation at $15 a share.[29] By reason of the fact that a market price upwards of $30 a share had immediately been established for the United States Electric Power Corporation common stock, the "rights"

[25] The "take-down" of the shares from American Founders Corporation was as follows (id., Commission's Exhibit No. X3902):

	Number of shares	Percent of total
By Investment Trust Associates, converted from 936,564 rights acquired by United Founders Corporation as stockholder of American Founders Corporation	374, 625	37
Other acquisitions by United Founders Corporation	221, 618	22
	596, 243	59
Investment Trust Associates, for own account	2, 224	
Founders Associates	892	
Other stockholders	415, 394	41
	1, 014, 753	100

United Founders Corporation sold these rights to Investment Trust Associates. This transaction is specially discussed hereinafter.

[26] In addition to the profits realized by American Founders Corporation on United States Electric Power stock, which have been detailed, other miscellaneous profits totaling $63,823.10 were gained by American Founders Corporation on this stock during 1929 and 1930. (Id., Commission's Exhibit No. X3732.)

[27] Id., Commission's Exhibits Nos. X3404–E2 and X3420–E2.

[28] Id., Commission's Exhibits Nos. X3421 (Schedule 19) and X3421–B.

[29] Id., Commission's Exhibit No. X4295.

to purchase at $15 a share attained a market value of $6 each.[30] Accordingly, the 936,564 rights which United Founders Corporation had received without cost from American Founders Corporation possessed a market value of $5,619,384.

On October 15, 1929, the last date at which the rights were exercisable, United Founders Corporation transferred them to Investment Trust Associates at $6 a "right," for a total of $5,619,384.[31] Investment Trust Associates at once converted the 936,564 rights into 374,625 shares of United States Electric Power Corporation common stock, paying $15 a share, or $5,619,375.[32] The total cost of this block of stock to Investment Trust Associates was therefore $11,238,759, equal to $30 a share. On October 18, 1929, three days after its purchase of the rights from United Founders Corporation, Investment Trust Associates sold to United Founders Corporation the entire block of 374,625 shares of United States Electric Power Corporation stock for $11,276,212.50, or $30.10 a share.[33] Investment Trust Associates realized a gross profit of $37,453.50, which transfer taxes reduced to $14,976 net.[34]

Upon completion of these transactions, the 374,625 shares of United States Electric Power Corporation stock were held in the portfolio of United Founders Corporation at a cost of $11,276,212.50 or $30.10 a share, instead of at $5,619,375 or $15 a share which the stock would have cost if United Founders Corporation had converted the "rights" directly.[35] At the same time, United Founders Corporation carried to "Dividend and Income" account the sum of $5,619,384 which represented the market value of the 936,564 rights at $6 a right.[36] In short, this transaction constituted still another instance of investment "write-up" similar in effect to the circular transactions recounted in an earlier section.[36a]

For the fiscal period ending November 30, 1929, United Founders Corporation reported total dividend and interest income in the sum of $8,145.847.[37] Although included in this sum and comprising 69% thereof was the sum of $5,619,384 realized in the manner described above from the United States Electric Power Corporation rights, the annual report to stockholders contained not the slightest intimation of this fact. However, in the address of the president, Louis H. Seagrave, at the annual meeting of the stockholders held on March 10, 1930 (which was later printed and sent to stockholders)[38] mention was made that "the item of interest and dividends $8,145,847.96, includes * * * rights (subsequently sold for cash) received on

[30] Since the rights distributed by American Founders Corporation permitted the purchase of one share of United States Electric Power Corporation common for each two and one-half shares of American Founders Corporation held, each right was effective for the purchase of two-fifths of one share of United States Electric Power Corporation stock, at $15 a share which was $15 under the then current market price.

[31] Op. cit. supra, note 3, Commission's Exhibit No. X4295.

[32] Ibid.

[33] Ibid.

[34] Id., Commission's Exhibit No. X3732.

[35] Id., Commission's Exhibit No. X4295.

[36] Id., at 26364 et seq. Upon receipt of the rights "Accrued Income Receivable" accounts was debited and "Dividends Received" account was credited; upon sale of the rights "Dividends Received" account was credited. (Ibid.)

[36a] See supra, p. 2295.

[37] Public Examination, American General Corporation, et al., Commission's Exhibit No. X3420.

[38] Id., Commission's Exhibit No. X3843.

American Founders common to buy common shares of United States Electric Power Corporation." Mr. Seagrave did not indicate the amount realized for these rights, and no indication was given that this sum constituted the greatest part of "Interest and Dividend Income" for the year. [39]

Not only had United Founders Corporation swelled its income account by the inclusion of the $5,619,384 realized from United States Electric Power Corporation rights, but it did so in a manner calculated to avoid payment of any income tax on this sum. Under the provisions of the Revenue Act then in effect, income received by a corporation in the form of *dividends* was not taxable on the part of the recipient.[40] Proceeding on the theory that the "rights" received from American Founders Corporation constituted *dividends* and not profits, United Founders Corporation credited its "Dividend Income" account with the sum of $5,619,384, the value of the "rights" as of the time received.[41] The sale of the rights by United Founders Corporation to Investment Trust Associates for $5,619,384 was then deemed by United Founders Corporation to have resulted in *no profit*, since the sales price merely equaled the value of the "dividend." [42] Inasmuch as dividends received by a corporation were not taxable, no income tax was paid by United Founders Corporation on the $5,619,384 realized from the receipt and sale of the rights. Royal E. T. Riggs, counsel to the Founders companies, stated: "We wanted to condition our bookkeeping so we would not pay a tax of $674,000." [43]

The theory that rights issued by a corporation to its stockholders giving such stockholders the privilege of purchasing shares of another company's stock owned by the corporation, constitute a dividend, in the absence of special circumstances, was subsequently rejected by the United States Supreme Court.[44]

One additional advantage accrued to United Founders Corporation from the transaction described above. It has been pointed out that upon acquiring the 374,624 shares of United States Electric Power

[39] No part of this sum of $5,619,384 realized by United Founders Corporation on this transaction was included in computing the total of intercompany profits for the 1928–1930 period (Appendix R), totaling $46,683,340. This total is comprised entirely of profits on purchases and sales of securities of the companies of the Founders Group and affiliates. Although the $5,619,384 "dividend" recorded by United Founders Corporation was derived from rights received through ownership of the stock of one affiliate (American Founders Corporation) to subscribe to stock of a second affiliate (United States Electric Power Corporation) and was realized by sale to a third affiliate (Investment Trust Associates), it was nevertheless deemed of somewhat different character from the other items included in the schedule and was therefore omitted. If not for this exclusion, the total would have been $52,302,724.

[40] Internal Revenue Act of 1928, Sec. 23 (p).

[41] Op. cit. supra, note 3, at 26359 et seq. See statements of Royal E. T. Riggs set forth in Appendix T, infra.

[42] Ibid.

[43] Id., at 26370; see also Appendix T, infra, p. 2471.

[44] *Palmer* v. *Commissioner of Internal Revenue*, 302 U. S. 63 (1937). The Court in this case stated (p. 71):

"The mere issue of rights to subscribe and their receipt by stockholders is not a dividend. No distribution of corporate assets or diminution of the net worth of a corporation results in any practical sense. Even though the rights have a market or exchange value, they are not dividends within the statutory definition. * * * They are at most options or continuing offers, potential sources of income to the stockholders through sale or the exercise of the rights. Taxable income might result from their sale, but distribution of the corporate property could take place only on their exercise. * * *

Corporation common stock, United Founders Corporation carried these shares in its portfolio at a cost of $30.10 a share, instead of the $15 a share cost they would have had if United Founders Corporation had exercised the rights directly. In this manner United Founders Corporation established for these shares a cost base approximately double the sum it otherwise would have been, with the result that if in the future it were to sell the United States Electric Power Corporation stock at a higher price, its taxable gain would be calculated from the higher cost base of $30.10 a share. In a subsequent section of this report [45] it will be shown that in October 1929 United Founders Corporation disposed of a portion of this block of United States Electric Power Corporation common stock at a price of $30.94 a share.[46] By reason of the higher cost base which United Founders Corporation had established for this stock, it was able to report a loss of $48,301 on this item in its income-tax return for the year instead of showing a taxable profit of $1,165,037 which would have resulted from a $15 cost base.

The testimony of Louis H. Seagrave with respect to the sale of the rights by United Founders Corporation to Investment Trust Associates, and related subjects, is set forth herewith: [47]

Q. Mr. Seagrave, you recall the transaction where United Founders, as the largest single stockholder of American Founders, received some 900,000 rights to purchase United States Electric common at $15 a share. On the 15th of October 1929, United Founders, which had received these rights at no cost, instead of exercising these rights and paying $15 for the 374,000 shares it was privileged to buy under these rights, entered into a transaction with Investment Trust Associates. Do you remember that situation?

A. Yes.

Q. Do you remember it [United Founders] sold the rights to Investment Trust Associates on October 15, 1920, which was the very last day on which the rights could be exercised at $6 per right, a price of $5,619,384 for those rights. And on that day Investment Trust Associates exercised the rights, paying for the 374,000 shares which it bought in the exercise of the rights, at the rate of $15 a share, a sum just a trifling amount more than that figure for which the rights had been—paid for the shares $5,619,375. Those figures are correct, aren't they, Mr. Carron?

Mr. Carron: Yes.

Q. So up to this point we have United Founders holding rights to purchase shares of United States Electric Power. It sells those rights to one of the affiliated concerns, Investment Trust Associates; Investment Trust Associates

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"We think that a distribution of assets by a corporation to its stockholders by means of a sale, to which it is committed by appropriate corporate action at a time when their sale price represents their reasonable value, is not converted into a dividend by the mere circumstance that later, at the time of their delivery to stockholders they have a higher value.

* * * * * * *

"It is decisive of the present case. * * * that distribution of corporate assets effected by the sale was not intended to be a means of distributing earnings, and that the price, when fixed, represented the fair market value of the property to be distributed."

It is to be noted the Court indicated that when rights are sold, as they were by United Founders Corporation, taxable income might *then* result. United Founders Corporation. however, paid no tax either on the value of the rights when received or on the $5,619,384 received on the sale to Investment Trust Associates.

[45] See infra, p. 2327.

[46] Op. cit. supra, note 3, Commission's Exhibit No. X3914.

[47] Id., at 26359 et seq.

exercises the rights, purchases the shares, and sells them back to United Founders. You remember that?

A. Yes; I remember that.

Q. And on October 18, 1929, Investment Trust Associates sold the 374,625 shares United States Electric Power common to United Founders Corporation. It had three days earlier bought the rights. This sale was at $30.10, a total of $11,276,212.50, and it showed Investment Trust Associates a profit of $14,976. That is correct, Mr. Carron?

Mr. Carron: Yes.

Q. Then, United Founders now, instead of having the stock as it might have had, at $5,619,375, enters the stock on its books at $11,276,212.50, the amount that it had paid to Investment Trust Associates; and then finally, to end this interesting picture—then the $5,619,384, the amount which it got from the sale of the rights to its affiliates, is evidenced in the November statement, the end of the fiscal year, November 30, 1929, as dividends. That is correct, isn't it?

A. I don't believe that is quite correct. I think that the amount of the difference between the amount of the value of the rights was entered as a dividend.

Q. The amount you got for the rights?

A. At the time of receipt.

Q. Yes.

A. It happened to be also the same amount.

Q. So that as a result, what this company did was to sell rights to an affiliate, have the affiliate purchase the stock, sell it three days later back to the parent company, United Founders, at a price which was about $5,000,000 more than the United Founders would have paid had it exercised the rights and bought the stock, and then United Founders registers an item of income amounting to $5,600,000, doesn't show it as a profit, but shows it as interest or dividends.

A. I still think there is a technical distinction. The amounts as you stated were about correct. I think the theory on which the amount was credited to income from dividends was, we took the value of the rights at the time of receipt by United Founders Corporation, which happened to be the price at which they were sold.

* * * * * * *

Q. The net facts are that you entered on your books these shares at $11,-000,000 instead of $5,600,000, and showed an income item of $5,600,000?

A. We showed an income of the value of the rights at the time of receipt, which I believe was correct in accordance with the advice we received.

Q. $5,600,000?

A. That is right. This transaction arose out of the complexities of the income-tax law. I would like to ask Mr. Riggs to answer for me, and I will be glad to adopt his answer.[48]

* * * * * * *

Q. Of course, you realize, Mr. Seagrave, that this was set up as the kind of income that went into earned surplus, and you were able to pay dividends out of the earned surplus, and the result was that you had this stock really marked up.

Mr. Riggs: The situation was exactly the same, I suppose, as if we bought 100 shares of steel at 100. The stock went up to 200, and we then sold the stock,

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[48] For the testimony of Mr. Riggs explaining in detail the tax aspect of this transaction, see Appendix T, infra, p. 2471.

taking 100 points profit, and bought back the stock two or three days later at 201 or 200½, and had the stock on the books at a higher cost, but you had a realized profit between the first purchase and sale.

Q. Exactly as if you had sold it to your wife and then bought it back?

A. I suppose it could have been sold on the market at the same price.

Q. This was the last day and you sold it to an affiliate.

Mr. Riggs: We have given you an explanation.

Allan H. Clarke, member of the firm of Clarke, Oakes & Greenwood, certified public accountants, who prepared and certified the financial report of United Founders Corporation for the fiscal year ended November 30, 1929,[49] when examined as to the omission from the reports of any mention concerning the transaction discussed above, testified:[50]

Q. Now, Mr. Clarke, * * * you are a member of the public; you read, after the crash in 1929, of this excellent performance by United Founders, while all the other companies are going through this troublesome time. Here United Founders comes through with $8,000,000 of interest and dividends, and you thereupon buy United Founders. Later you find what this $5,000,000 is. That as the result of the transaction, United Founders has paid $5,000,000 more for stock than it would have had to pay if it had exercised the rights; don't you think you would have been good and sore, if you weren't told about it?

A. Well, I certainly think that if I had seen through the transaction and realized it, I would undoubtedly, probably, if I had a substantial interest in the company, direct some questions concerning it to find out why it was done; no question about that.

* * * * * * *

Q. If you had sent an analyst in, or one of your men, to investigate this situation, and he had come back to you and had not told you what that $5,000,000 was about, you probably would have discharged him, wouldn't you?

* * * * * * *

A. Oh, yes, indeed; I probably would.

Q. Well, now, why isn't the public entitled to be informed when, on the statement that I have given to you, there isn't any real profit, there can't be a real profit, in the transaction? Why wasn't the public entitled to be informed at that time that $5,000,000 of this $8,000,000 figure was represented by a mere shuffling of the cards?

A. I think the public was entitled to be informed, if the accountant felt as a matter of fact that the company hadn't derived the profit, but I think the accountant for the company felt the company had derived the profit. It is a question of fact. May I add just a few words to that, Mr. Stern, in corroboration?

Q. Yes.

A. I don't think that by any means the accountants should rely on their fact-establishing on Government decisions and what not. But before that report of United Founders was published that year, the Federal taxing authorities had taken a position on that very question which to a large extent corroborated or entirely corroborated, let us say, the accountants' decision that that was income.

Q. Mr. Clarke, we needn't rest on that, because in other transactions that we have discussed here losses were registered for the purpose of income tax, but

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[49] Op. cit. supra, note 3, Commission's Exhibit No. X3420 (E–2).

[50] Id., at 26768 et seq.

were not shown in the statements that were given by accountants,[51] so that we needn't rely upon whatever technical practices may have been indulged in to meet the technical assumptions of the income-tax law. Those things may be different, as you recognize, and I think you stated before—some of the witnesses certainly have stated—those things are different from actualities—

A. That is true.

Q. —that you report to your stockholders.

A. That is true. At the same time, I mentioned that my decision in that case on the question of whether that was income wasn't based on the Government's decision. I simply mentioned the fact that my decision was to some extent corroborated by the Government action.

By Mr. Riggs:

Q. It was a very important point as to whether this was an item which was taxable or nontaxable, wasn't it?

A. Indeed it was.

Mr. Stern: It may be a very important point as to whether it is taxable or nontaxable, and I haven't challenged that in any way here, although events subsequently disclosed that the legal assumption was wrong, but I am assuming that the legal assumption was right and that the accounting assumption in the way it was entered on the books may have been correct. The thing that I am directing myself to is this: Was the public properly apprised of the situation, or didn't the accountants become here the instrumentalities of the presentation to the public of what was really and substantially an inaccurate picture?

Q. Now, addressing yourself to that, Mr. Clarke, let me ask you these questions. First, is there any substantial profit where a corporation sells to an affiliate and takes back from an affiliate at substantially the same price?

A. Generally speaking, no. There might be in instances, but I would say, generally speaking, no.

* * * * * * *

Q. Corporation A sells to its affiliate B at a profit of $5,000,000, and then buys back the same number of shares from the affiliate at an increased price, at the price to it originally, plus the $5,000,000. Is there any real profit in that transaction?

A. There might well be in some instances if the sale was a bona fide sale and subsequently within a corporation's fiscal year—if subsequent to the time it made the sale, the corporation, for reasons best known to its directors, wanted to repossess that stock and had to pay a higher price, it would be. If it were done merely for the purpose of stepping up the value, why of course there was no profit.

Q. Where the transaction occurs in three days, isn't the transaction so suspect that you are obligated to show to the stockholders the nature of that transaction by some footnote or otherwise?

A. I would say that you are obligated certainly to examine it very carefully, and I would say today under present procedure, by all means. Just today, I would consider that the receipt of the rights by (in this instance) United Founders Corporation, and assuming that our technical tax laws complied with our ideas; that is, that it was generally known to be a profitable transaction or a transaction with ultimate profit, I certainly believe it would be very wise for the corporation's income statement to set forth the source of the income and all pertinent facts concerning it.

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[51] See note 33, infra, p. 2340.

Q. Going a little further, Mr. Clarke, where the corporation sells to its affiliate the rights for $5,000,000 and buys back the stock from the affiliate three days later, isn't that the kind of transaction which you would feel bound to make some note of?

A. Yes; I would today, by all means.

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By Mr. Riggs:

Q. Mr. Clarke, you remember discussing this matter with me along at the time in 1931 and giving me an opinion upon two questions here: first, Was the receipt of the rights a proper credit to dividends? And second, Was the publication of the statement of income, which includes dividends, consisting in part of such rights, without distinguishing them from dividends and actual cash, proper?

* * * * * * *

* * * I don't think I brought out on the record this fact, but this opinion of yours answered both of those questions in the affirmative?

A. Yes, sir.[52]

W. H. Conkling of Loomis, Suffern & Fernald, the accounting firm whose name appeared on the United Founders Corporation's report to stockholders for the fiscal year ended November 30, 1929, as "Consulting Accountants,"[53] likewise conceded in his testimony that, at least by present day accounting standards, segregation would be made of the income discussed above. Mr. Conkling testified as follows:[54]

Q. Mr. Conkling, you have heard Mr. Clarke's testimony about this transaction in USEP rights, $5,000,000 transaction. Is there anything you want to say about that? Were you the consulting accountant in that transaction?

A. Well, I think I can only corroborate what Mr. Clarke said. We felt it was a dividend properly reported as a dividend, and was included in the statement. I don't know what more I can add to it.

Q. I am not concerned with the technical justification of something that would not now be technically justified under the decisions now existing. I am only concerned with the question of disclosure or nondisclosure to the public.

A. I will say that I think today we would separate out that amount. Perhaps other amounts that may have been important amounts with affiliated companies, although in the case of that statement, you must recognize that United Founders was primarily a holding company with its principal investments in securities of affiliates, not all of them completely controlled, but at least we call them affiliates.

Q. What difference does that make, Mr. Conkling? A stockholder isn't any more pleased by being misled by a holding company than he is by an investment company?

A. What I mean to say is they must have known from the statement itself that a large amount of dividends must have come from those holdings.

Q. Mr. Conkling, I will show you these figures in the report and the breakdown of those figures and after asking you this question, if there is anything you want to say along the lines you were saying when I interrupted you by my last question, you may do so.

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[52] For copy of memorandum prepared by Mr. Clarke on this subject for United Founders Corporation, see op. cit. supra, note 3, Company's Exhibit No. 7.

[53] Id., Commission's Exhibit No. X3420 (E-2).

[54] Id., at 26789 et seq.

You will observe in the annual report for the United Founders for the year ended November 30, 1929, interest and dividends are lumped together $8,145,000. Of that sum, $5,619,000 represented what was called on the books the income received by virtue of these rights.

That, obviously from your viewpoint today, would be a totally inadequate picture?

A. I think so.

c. Nondisclosure of Profits Recorded by Founders Companies on Sale of Standard Gas and Electric Company Stock to United States Electric Power Corporation, and Additional Sums Placed in Income Accounts on Distribution of United States Electric Power Corporation Stock

Discussed in the two preceding subsections were the sums of $1,781,833 recorded as profits by American Founders Corporation and United Founders Corporation from the distribution to their stockholders of 2,278,340 shares of United States Electric Power Corporation common stock through "rights," and the $5,619,384 placed in income account by United Founders Corporation in connection with the receipt and sale of these rights. These increments to income accounts totaling $7,401,217 were supplemented by additional gains in connection with the distribution of United States Electric Power Corporation stock, under the following circumstances.

It will be recalled [55] that on September 10, 1929, American Founders Corporation and United Founders Corporation agreed to purchase from United States Electric Power Corporation, in addition to the two million shares of comon stock intended for distribution to their stockholders through "rights," 700,000 shares of Class A stock, with warrants at $10 a share and 350,000 shares of common stock with warrants at $13.50.[56] The warrants attached to both the Class A stock and the common stock entitled the holder to purchase one additional share of United States Electric Power Corporation common stock on or before January 2, 1940, at $25 a share.[57] In addition, with the Class A stock there was distributed a second warrant similar to the others but which was not attached to the stock and was therefore termed a "free" warrant.[58] The purchase price of this stock and the warrants totaled $11,725,000, which was paid, as has previously been stated, by the delivery to United States Electric Power Corporation of 61,710 shares of Standard Gas and Electric Company common stock at $190 a share.[59] Of the 61,710 shares of Standard Gas and Electric Company stock which were delivered to United States Electric Power Corporation, 22,600 shares were supplied by five underlying Founders companies and the balance of 39,110 shares was furnished by American Founders Corporation and United Founders Corporation themselves.[60] The 61,710 shares of Standard Gas and Electric Company stock had cost

[55] See discussion supra, p. 2314.

[56] Op. cit. supra, note 3, Commission's Exhibit No. X3904.

[57] Ibid.

[58] Id., Commission's Exhibit No. X4018.

[59] Id., Commission's Exhibits Nos. X4031 and X3422 (A-4).

[60] Id., Commission's Exhibit No. X3907.

the various Founders companies $9,048,160, and at $190 a share they realized $11,724,900, a profit of $2,676,740.[61]

In return for the Standard Gas and Electric Company stock, American Founders Corporation distributed to the five Founders companies 170,000 shares of United States Electric Power Corporation common stock with warrants, and 60,000 "free" warrants. United Founders Corporation retained for its own account 350,000 shares of Class A stock and 350,000 "free" warrants; and American Founders Corporation retained 350,000 shares of Class A stock, 180,000 shares of common stock and 290,000 "free" warrants.[62]

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[61] Ibid. The distribution of this stock and warrants and the realization of the $2,676,740 profit on the Standard Gas and Electric Company stock are shown in the following table (id., Commission's Exhibit No. X3907):

	Acquired from U. S. Electric Power Corp.				
	Class A stock		Common stock		Number of detached warrants acquired at no cost
	Shares acquired	Cost at $10 per share	Shares acquired	Cost at $13.50 per share	
Int'l Sec. Corp. of America			60,000	$810,000	20,000
Second Int'l Sec. Corp			30,000	405,000	10,000
U. S. & British Int'l Co., Ltd			25,000	337,500	10,000
American & General Sec. Corp			25,000	337,500	10,000
Investment Trust Associates			30,000	405,000	10,000
American Founders Corp.: 180,000 common shares acquired and 290,000 warrants acquired comprise 128,000 shares and 260,000 warrants acquired for its own account, and 52,000 shares and 30,000 warrants acquired for account of other allied companies not shown above	350,000	$3,500,000	180,000	2,430,000	290,000
United Founders Corporation	350,000	3,500,000			350,000
Cash paid to U. S. Electric Power Corp					
Total	700,000	7,000,000	350,000	4,725,000	700,000

	Sold to U. S. Electric Power Corporation			
	Standard Gas & Electric Co.—Common stock			
	Shares sold	Total sales at $190 per share	Cost of sales	Realized profit
Int'l Sec. Corp. of America	10,200	$1,938,000	$1,394,972.24	$543,027.76
Second Int'l Sec. Corp	2,200	418,000	262,834.00	155,166.00
U. S. & British Int'l Co., Ltd	2,100	399,000	317,517.90	81,482.10
American & General Sec. Corp	3,400	646,000	451,894.00	194,106.00
Investment Trust Associates	4,700	893,000	714,353.00	178,647.00
American Founders Corp.: 180,000 common shares acquired and 290,000 warrants acquired comprise 128,000 shares and 260,000 warrants acquired for its own account, and 52,000 shares and 30,000 warrants acquired for account of other allied companies not shown above	6,610	1,255,900	932,138.30	323,761.70
United Founders Corporation	32,500	6,175,000	4,974,450.00	1,200,550.00
		11,724,900		
Cash paid to U. S. Electric Power Corp		100		
Total	61,710	11,725,000	9,048,159.44	2,676,740.56

[62] Out of the 180,000 shares of common stock and 290,000 "free" warrants, American Founders Corporation turned over 52,000 shares of common stock and 30,000 warrants to other Founders companies and affiliates.

In addition to the profits gained by the underlying Founders companies on the sale of their Standard Gas and Electric Company stock to United States Electric Power Corporation, as shown in the table in footnote 61, these companies realized further profits aggregating $620,400 through the sale of the United States Electric Power Corporation stock and warrants acquired in exchange for the Standard Gas and Electric Company stock, in the following manner:

International Securities Corporation of America, which had acquired 60,000 shares of United States Electric Power Corporation common stock and 20,000 warrants at a total cost of $810,000, based on a price of $13.50 a share of common stock, sold its common stock on November 23, 1929 (two months after acquisition) at $15 a share, or a total of $896,400 net, and a profit of $86,400.[63] In May 1930 the company sold its 20,000 "free" warants at $5 a warrant for a total of $99,699 net. International Securities Corporation of America thereby realized an aggregate profit of $186,099 on the distribution of its United States Electric Power Corporation stock and warrants.[64] It is to be noted, however, that this profit was gained in violation of the provisions of International Securities Corporation of America's bylaws and indentures and its publicized management policy, a subject which will be discussed in detail in a subsequent section.[65]

On May 2, 1930, United Founders Corporation obtained from United States Electric Power Corporation an option to purchase up to one million additional shares of United States Electric Power Corporation's common stock at $14 a share on or before July 31, 1930.[66] United Founders Corporation in turn entered into an agreement with Founders General Corporation in which Founders General Corporation undertook to find purchasers for, or, under certain conditions, itself to purchase, 500,000 shares of United States Electric Power Corporation stock at $15.50 a share.[67] To aid it in carrying out this agreement, Founders General Corporation organized a banking and selling syndicate which commenced operations by taking down a block of 100,000 shares of United States Electric Power Corporation stock from United Founders Corporation at the agreed price of $15.50 a share.[68] At the same time, this syndicate purchased from three of the Founders companies 80,000 shares of United States Electric Power Corporation common stock which they had acquired coincidentally with Interna-

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[63] Op. cit. supra, note 3, Commission's Exhibit No. X3908.

[64] Ibid.

[65] In the circulars offering for sale the securities of International Securities Corporation of America, these investment restrictions were stated as follows (id., Commission's Exhibit No. X3401):

> The corporation will not invest its funds in securities of any corporation or organization unless such corporation or organization, or its predecessor, has been established at least four years prior to such investment.

International Securities Corporation's investment in the stock of the newly formed United States Electric Power Corporation was not the first or the only violation of these publicized investment restrictions. Other instances of such violations, resulting in profits of approximately six million dollars, are discussed hereafter. (See Sec. B, 6, infra.)

The sale by International Securities Corporation of America of its United States Electric Power Corporation common stock on November 23, 1929, at the low price of $15 a share is apparently explained by the fact that International Securities Corporation of America's fiscal period closed November 30, and International Securities Corporation of America would have been compelled to publish in its portfolio these prohibited securities.

[66] Op. cit. supra, note 3, Commission's Exhibit No. X4074.

[67] Id., Commission's Exhibit No. X4081.

[68] Id., Commission's Exhibit No. X4296.

tional Securities Corporation of America,[69] at $16.50 a share, which represented a profit to them of $3 a share, or $235,200 net.[70] Simultaneously, this syndicate purchased from these Founders companies all the United States Electric Power Corporation warrants which they held, 60,000 in all, at $5 a warrant for a total of $298,800 net, which was entirely profit, since these warrants had cost them nothing.[71] The aggregate net profit realized by the underlying Founders companies on the disposition of their United States Electric Power Corporation stock and warrants totaled $620,400.[72]

United Founders Corporation, on the 100,000 shares of United States Electric Power Corporation common stock which were taken down by the syndicate at $15.50 a share, realized at profit of $1.50 a share, or $150,000, which was reduced by tax expense to $144,000 net.[73] In addition to these 100,000 shares, United Founders Corporation disposed of another 100,000 shares of the United States Electric Power Corporation stock covered by its option, to two officers of the Founders Group, F. B. Erwin and C. F. Coombs, at $15 a share, for a net profit of $94,000. This brought the combined profit on these 200,000 shares of United States Electric Power Corporation stock to $238,000.[74]

Without taking into account the $5,619,384 recorded by United Founders Corporation, in September 1929, as dividend income,[75] the aggregate net profits derived by United Founders Corporation in 1929 and 1930 from the distribution of United States Electric Power Corporation stock equaled $790,272.21.[76] This total makes allowances for a book loss of $48,301 recorded by United Founders Corporation on the sale, in October 1929, of a block of 207,302 shares of United States

[69] See note 61, supra.

[70] Op. cit. supra, note 3, Commission's Exhibits Ncs. X4296 and X3909.

[71] Id., Commission's Exhibit No. X3910. The syndicate proved to be a failure, and the 60,000 warrants remained with Founders General Corporation until they were disposed of years later at almost a complete loss. In all, Founders General Corporation suffered losses in connection with this syndicate totaling $2,760,715, while other Founders companies benefited to the extent of $678,600 from the activities of the syndicate. Further details with respect to the operation of this syndicae are furnished, infra, p. 2331.

[72] The break-down of this profit is shown in the following table (op. cit. supra, note 3, Commission's Exhibits Nos. X3732 and X3903):

Profits realized by	Profits realized from disposition of United States Electric Power Corporation		Total profits realized
	Common stock	Detached warrants	
International Securities Corporation of America	$86,400	$99,600	$186,000
Second International Securities Corporation	88,200	49,800	138,000
U. S. & British International Company, Ltd	73,500	49,800	123,300
American & General Securities Corporation	73,500	49,800	123,300
Investment Trust Associates		49,800	49,800
Total	321,600	298,800	620,400

[73] Id., Commission's Exhibit No. X3913.

[74] Ibid.

[75] See supra, p. 2319.

[76] Op. cit. supra, note 3, Commission's Exhibit No. X3732. This sum does not include profits of $36,961.82 realized by United Founders Corporation from sale of United States Electric Power Corporation warrants. (Ibid.) Founders General Corporation also realized $5,710.48 on disposition of a block of its United States Electric Power Corporation warrants. (Ibid.)

Electric Power Corporation stock at $31 a share to Founders General Corporation[77] for the purpose of covering an oversold position.[78] By reason of the fact that the cost of this United States Electric Power Corporation stock to United Founders Corporation had been inflated to approximately $31.17 a share by the $5,619,384 realized by United Founders Corporation on the sale to Investment Trust Associates, an apparent loss of $48,301.36 resulted instead of a profit of $1,165,037.[79] As has previously been pointed out, United Founders Corporation thereby effected a substantial tax saving.[80]

d. Nondisclosure of Losses Suffered by Founders General Corporation in the Distribution of the Stock of United States Electric Power Corporation

In previous sections of this chapter the sums entered in income accounts by the various Founders companies in connection with the distribution of United States Electric Power Corporation stock have been discussed. In all, those sums totaled $2.713,403.17,[81] not including the

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[77] Id., Commission's Exhibit No. X3914.

[78] Id., Commission's Exhibit No. X4069.

[79] This subject was alluded to above, and is discussed further infra. The average cost of these shares had been inflated by the $5,619,384 "dividend" recorded by United Founders Corporation, to $30 a share. They were added to other shares acquired at a higher cost, making the average net cost approximately $31.17 a share. (Op. cit. supra, note 3, Commission's Exhibit No. X3914.) If the rights had been converted by United Founders Corporation without the sale and repurchase from Investment Trust Associates they would have cost $15 a share, the exercise price. On that basis, the average cost of all United Founders Corporation holdings would have been $25.32 a share, instead of $31.17. Since the selling price of the 207,302 shares sold to Founders General Corporation was $30.94 a share net, a profit of $5.62 a share, or $1,165,037, would have been recorded.

[80] This subject has been alluded to above and is discussed further infra. The various sums entered in income account by United Founders Corporation are summarized in the following table:

Net profit from the distribution, in September 1929, of 733,326 shares of the common stock of United States Electric Corporation through rights, to United Founders Corporation		$600, 573. 57
Net profit from sale of 200,000 shares in May 1930:		
Sales proceeds	$3, 038, 000	
Cost	2, 800, 000	
		238, 000. 00
Total profits		838, 573. 57
Loss recorded by United Founders Corporation on sale in October 1929 to Founders General Corporation of 207,302 shares with which Founders General Corporation covered an oversold position:		
Sales proceeds, $31 per share, less tax 6¢, net total	$6, 413, 923. 88	
Cost, average price, $31.17	6, 462, 225. 25	
		48, 301. 36
Net profits recorded		790, 272. 21

[81] See the following:

Recorded by American Founders Corporation on the sale to its stockholders of 1,014,753 shares of United States Electric Power Corporation's common stock at $15.00 per share which stock had cost American Founders Corporation $13.50 per share	$1, 181, 259. 56
Miscellaneous profits recorded by American Founders Corporation	63, 823. 10
Total, American Founders Corporation	1, 245, 082. 66
Net profit recorded by United Founders Corporation on distribution of United States Electric Power Corporation's stock	790, 272. 21
United Founders Corporation profits from sale of United States Electric Power Corporation warrants	36, 961. 82
Profits recorded by Founders General Corporation from sale of United States Electric Power Corporation warrants	5,710. 48
Net profit recorded by Investment Trust Associates in connection with its purchase from United Founders Corporation of "rights" and resale of stock to United Founders Corporation	14, 976. 00
Profits recorded by five Founders companies as detailed in preceding pages	620, 400. 00
Total profits recorded by Founders Group	2, 713, 403. 17

"dividend" of $5,619,384 recorded by United Founders Corporation in connection with the receipt and sale of "rights," nor the profits of $2,676,740.56 realized by the various Founders companies on the sale of their Standard Gas and Electric stock to United States Electric Power Corporation at the time of their purchase of the latter's stock.

Unlike the other Founders companies, however, Founders General Corporation not only did not realize profits in connection with the distribution of United States Electric Power Corporation stock but it actually suffered substantial losses. These losses were entered on the books of Founders General Corporation in the sum of $1,029,024.44 [82] but they actually aggregated $3,401,239 if account is taken of a $2,372,215 loss which was not recorded by the Founders management through a form of circumvention described in detail hereafter. The loss of $1,029,024.44 which Founders General Corporation did record on its books, when balanced against the profits of $2,713,403.17 realized by the other Founders companies, reduces the total net profit of the Founders group from the distribution of United States Electric Power Corporation stock to $1,684,378.73.[83]

The role played by Founders General Corporation in the distribution of United States Electric Power Corporation stock was, in brief outline, as follows:

To Founders General Corporation was assigned by agreement among the sponsors of United States Electric Power Corporation, as has already been stated, the function of distributing the common stock of United States Electric Power Corporation to the public and of controlling the market in it.[84] In September 1929 United States Electric Power Corporation authorized the issuance of 1,000,000 shares of its common stock to Founders General Corporation, at a price to be equivalent to the selling price obtained by Founders General Corporation on the market, less one point.[85] On September 26, 1929, Founders General Corporation took down 500,000 shares of common stock from United States Electric Power Corporation.[86] However, during the month of September, Founders General Corporation had sold a total of 887,485 shares of United States Electric Power Corporation's common stock at an average of $28.8148 per share.[87] It had also supported the market by accepting offerings of 72,189 shares of United States Electric Power Corporation's stock at an average price of $32.405 per share.[88] Consequently, at the end of September 1929, Founders General Corporation had an oversold position in the stock

[82] Op. cit. supra, note 3, Commission's Exhibit No. X3732.

[83] As a result of the nonconsolidation of the accounts of Founders General Corporation with those of its parent, American Founders Corporation, a subject discussed in detail, supra, p. 2306, the profits of $1,245,082 realized by American Founders Corporation in 1929 and 1930 from dealings in United States Electric Power Corporation stock, were included in the profits reported to the stockholders of the Founders companies, whereas the loss of $1,029,024 suffered by Founders General Corporation, the wholly owned subsidiary of American Founders Corporation, was never reported.

[84] Op. cit. supra, note 3, Commission's Exhibit No. X4025: "The current junior financing of the Corporation [United States Electric Power Corporation] will be done through the agency of Founders General Corporation and such Founders General Corporation will be in control of the marketing of the common stock of the Corporation."

[85] Id., Commission's Exhibit No. X4031.

[86] Id., Commission's Exhibits Nos. X3918 and X4069.

[87] Ibid.

[88] Ibid.

of United States Electric Power Corporation aggregating 315,296 shares, and it had earned $500,000.00 in commissions, at the rate of one dollar per share on the 500,000 shares taken down from United States Electric Power Corporation.[89]

In October, Founders General Corporation took down an additional 100,000 shares from United States Electric Power Corporation thereby earning $100,000 in commissions, and it also purchased 207,302 shares from United Founders Corporation at $31.00 a share, a transaction which has previously been described.[90] In the same month Founders General Corporation sold a total of 217,924 shares of United States Electric Power Corporation's common stock, but was forced to repurchase from dealers in supporting the market 338,877 shares.[91] By the end of October, Founders General's previously oversold position was transformed into a long position to the extent of 112,959 shares, and its activities showed a loss of $707,092.46.[92]

During the month of October 1929, United States Electric Power Corporation authorized the issuance of 1,000,000 additional shares of its common stock at $29.25 a share, to a syndicate composed of Founders General Corporation, The Harris Forbes Corporation, and W. C. Langley & Co.[93] Among themselves the syndicate members agreed that the participations would be divided 40% to Founders General Corporation and 30% each to The Harris Forbes Corporation and W. C. Langley & Co.[94] The syndicate members in turn organized a group of dealers to distribute the stock to the public at $33.25 per share, the dealer to receive a concession of $1.75 per share.[95] Before the syndicate commenced active operations, however, the historic market collapse at the end of October 1929 placed an effective quietus on the entire plan. On October 29, United States Electric Power Corporation canceled the authorized issuance of 1,000,000 shares,[96] dealers canceled their commitments[97] and the syndicate thereafter ceased operations.

In anticipation of the take-down of common stock from United States Electric Power Corporation, Founders General Corporation had conducted advance activities on behalf of the syndicate which resulted in a loss of $425,380.92.[98] The manner in which this loss should be divided among the syndicate participants was the subject of discussion for some time and was finally settled in June 1930 in the fashion indicated by the following memorandum sent by Louis P. Carron of United Founders Corporation to Mr. Badenhausen, another executive of the same company:[99]

Mr. Seagrave made a settlement with W. C. Langley and Company and the Harris Forbes Corporation, participants in the old United States Electric Power

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[89] Ibid.

[90] See supra, p. 2327, and op. cit. supra, note 3, Commission's Exhibit No. X3918.

[91] Op. cit. supra, note 3, Commission's Exhibits Nos. X3918 and X4069.

[92] See id., Commission's Exhibit No. X3918 for a summary analysis of these transactions.

[93] Id., Commission's Exhibits Nos. X4068 and X4031.

[94] Ibid.

[95] Id., Commission's Exhibit No. X4068.

[96] Id., Commission's Exhibit No. X4031.

[97] Id., Commission's Exhibit No. X4069.

[98] Id., Commission's Exhibit No. X3921.

[99] Id., Commission's Exhibit No. X3922.

Corporation syndicate. The final settlement is that Founders General Corporation stands the whole loss.

Accordingly, Founders General Corporation suffered these additional losses which by November 30, 1929 (the close of the fiscal period), increased its total loss on United States Electric Power Corporation's stock, after all proper deductions were made, to $847,-720.16,[100] of which $737,989.99 was recorded on the books for 1929, and the balance of $109,730.17 in 1930.[101]

During 1930 Founders General Corporation recorded on its books a net loss of $291,034.45 (including the $109,730.17 mentioned above) in connection with its activities in the stock of United States Electric Power Corporation,[102] thereby showing an aggregate loss for 1929 and 1930 of $1,029,024. In this same year, however, Founders General Corporation suffered another loss of $2,372,215 in connection with United States Electric Power Corporation stock which was never recorded on the books of Founders General Corporation. This transpired in the following manner:

In May 1930, United States Electric Power Corporation, as has already been indicated,[103] gave an option to United Founders Corporation to purchase up to 1,000,000 shares of its common stock at $14.00 per share.[104] United Founders Corporation in turn contracted with Founders General Corporation to find purchases for 500,000 shares of this stock, Founders General Corporation making a firm commitment to take down 100,000 shares at $15.50.[105] Founders General Corporation thereupon organized a banking group and a selling group to aid it in these operations.[106] These groups succeeded in distributing only 30,955 shares of United States Electric Power Corporation's stock,[107] and Founders General Corporation continued alone. At the start of November 1930, near the close of the fiscal year, Founders General Corporation had a long position in this stock to the extent of 315,768 shares, at a cost of $4,424,707.51.[108] In November, Founders General Corporation transferred these 315,768 shares of United States Electric Power Corporation common stock to American Founders Corporation and received in exchange from American Founders Corporation a group of miscellaneous securities which the latter had in its portfolio.[109] These securities at the date of transfer to American Founders Corporation possessed a total market value of $2,052,492, which was $2,372,215 below the cost to Founders General Corporation of the United States Electric Power Corporation stock.[110] Founders General Corporation avoided recording this loss on its books by the simple expedient of entering the value of securities received at $4,424,-707.51, the exact cost of the United States Electric Power Corporation

[100] Id., Commission's Exhibit No. X3732.
[101] Ibid.
[102] Ibid.
[103] See supra, p. 2306.
[104] Op. cit. supra, note 3, Commission's Exhibit No. X4074.
[105] Id., Commission's Exhibit No. X4081.
[106] Ibid.
[107] Id., Commission's Exhibit No. X4296.
[108] Id., Commission's Exhibit No. X4274.
[109] Ibid.
[110] Ibid.

stock surrendered on the exchange.[111] This exchange of securities between Founders General Corporation and its parent company, American Founders Corporation, effectuated a three-fold gain for the two companies concerned:

(*a*) Through the effective device employed it concealed a realized loss of $2,372,215 suffered by Founders General Corporation.

(*b*) It permitted American Founders Corporation to clear out of its portfolio, immediately before the close of the fiscal period (as of which date the contents would be published), securities of questionable character and value,[112] by transferring them to the portfolio of Founders General Corporation (which portfolio was not published).

(*c*) American Founders Corporation by virtue of this transaction was enabled to take a tax deduction in its income-tax return for 1930, based on a loss of $2,372,215,[113] as will be shown hereafter.[114]

With this exchange the dealings of Founders General Corporation in the stock of United States Electric Power Corporation were brought to an end.[115]

5. FAILURE TO SEGREGATE AND REVEAL SUMS PLACED IN INCOME ACCOUNTS BY FOUNDERS COMPANIES FROM DEALINGS IN THE SECURITIES OF AMERICAN AND CONTINENTAL CORPORATION AND UNITED STATES & OVERSEAS CORPORATION

a. Profit Recorded by American Founders Corporation on Sale of Common Stock of American and Continental Corporation

In connection with the acquisition of partial control of American and Continental Corporation, an investment and finance company organized in 1924 by a group of banking houses,[1] American Founders Corporation, in June 1929, acquired 12,501 shares of Class A stock of American and Continental Corporation for $418,034.39, and 375,003 shares of common stock of the same company for $12,540,128.86, or $33.44 a share.[2] On July 8, 1929, American Founders Corporation entered into an agreement with The Harris Forbes Corporation whereby the latter agreed to attempt to distribute to the public up to 325,000 shares of American and Continental Corporation common stock at $40 a share, $37 to be paid to American

[111] Id., Commission's Exhibits Nos. X4297 and X3911.

[112] Id., Commission's Exhibit No. X3911.

[113] Id., Commission's Exhibit No. X4274.

[114] See infra.

[115] United States Electric Power Corporation ultimately went into receivership, and the entire net investment of the Founders Group totaling approximately $70,000,000 was lost. In addition, the stockholders of the Founders Group who had exercised the rights issued to them by the group sustained a loss of approximately $17,000,000. For a detailed account of the activities of United States Electric Power Corporation, see Pt. Four of the over-all report.

[1] Organized October 1924 by Kuhn, Loeb & Co., International Acceptance Bank, Inc., Dillon, Read & Co., and The North American Company. (Public Examination, American General Corporation, et al., at 22115.)

[2] Id., Commission's Exhibit No. X4302. At the time of purchase American Founders Corporation received 100,000 shares of Class A and 16,251 shares of Class B stock, but these were subsequently reclassified into Class A and common stock in the quantities stated.

Founders Corporation and $3 to be retained by The Harris Forbes Corporation as commission.[3] Pursuant to this agreement, The Harris Forbes Corporation, on July 23, 1929, took down from American Founders Corporation 325,000 shares of American and Continental Corporation common stock at $40 a share and remitted to American Founders Corporation $37 a share.[4] Since the cost of this stock to American Founders Corporation was $33.44 a share, American Founders Corporation realized a profit of $3.56 a share, or $1,156,-975.26 in the aggregate.[5]

The Harris Forbes Corporation and the interests associated with it in this venture encountered difficulty in attempting to dispose of the entire block of 325,000 shares of American and Continental Corporation stock. As of October 9, 1929, a trading account operated in this stock by these interests showed a long position of 93,390 shares,[6] and market conditions toward the latter part of October made distribution even more difficult.

On October 22, 1929, The Harris Forbes Corporation entered into an agreement with Founders General Corporation by which the latter purchased from The Harris Forbes Corporation for the account of United Founders Corporation 115,000 shares of common stock of American and Continental Corporation at $37 a share for a total of $4,255,000.[7] At the same time The Harris Forbes Corporation purchased from Founders General Corporation 75,000 shares of United Founders Corporation common stock at $68.50 a share for a total of $5,137,500.[8] This transaction constituted an arrangement by which The Harris Forbes Corporation was permitted, three months after purchase, to return to the Founders system, at cost, 115,000 shares of American and Continental Corporation stock for which the market had proved to be stale, in exchange for United Founders Corporation stock, which possessed superior marketability. By the return of these shares to United Founders Corporation instead of to American Founders Corporation, from which they were purchased, American Founders Corporation was able to show in its financial report for the fiscal year ending November 30, 1929, the profit of $3.56 a share previously entered on these 115,000 shares at the time of their sale to The Harris Forbes Corporation as part of the block of 325,000 shares. Consequently, the financial report of American Founders Corporation as of November 30, 1929, contained $409,400 of net income gained on a sale of shares which had, within the same period, been returned to the Founders system at their former selling price and were being held by United Founders Corporation, a close affiliate of the reporting company.

In fact, by a subsequent transaction, these shares were returned physically to American Founders Corporation itself. In November 1930, this block of 115,000 shares of American and Continental Corporation common stock, which had cost United Founders Cor-

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[3] Public Examination, American General Corporation, et al., Commission's Exhibit No. X3756.

[4] Id., Commission's Exhibit No. X4303.

[5] Id., Commission's Exhibit No. X3732.

[6] Id., Commission's Exhibit No. X4303.

[7] Id., Commission's Exhibits Nos. X3759–A and X4303.

[8] Ibid.

poration $37 a share (a total of $4,255,000), together with 24,137 additional shares of American and Continental Corporation stock acquired by United Founders Corporation in the interim at an average cost of $24.78 a share (a total of $598,200.13), was transferred by United Founders Corporation to American Founders Corporation in exchange for a group of diverse securities consisting chiefly of common stock and warrants of United States Electric Power Corporation.[9]

The American and Continental Corporation stock had a market value of $2,782,740 at the time of the exchange, and the securities surrendered by American Founders Corporation had a market value of $2,592,261.88.[10] American Founders Corporation, however, disregarding these market values, entered the sum of $4,853,200.13 in its books as the cost value of the American and Continental Corporation stock received from United Founders Corporation, this sum being the full amount which the securities transferred by it on the exchange had originally cost.[11]

Included in the block of American and Continental Corporation stock which came on the books of American Founders Corporation at a figure inflated more than $2,000,000 in excess of market value, was, as has been indicated, the 115,000 shares on which American Founders Corporation had previously recorded $409,400 as a "profit."

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[9] The details of this transaction are shown in the following schedule (id., Commission's Exhibit No. X3925):

	Number of shares	Cost per books		Market value November 30, 1930	
		Per share	Total cost	Per share	Total market value
Securities Acquired by American Founders Corporation					
American and Continental Corp. common	139,137	$34.88	$4,853,200.13	$20.00	$2,782,740.00
Securities Surrendered in Exchange by American Founders Corporation					
Seaboard Investment Trust	5,000	40.00	200,000.00	45.00	225,000.00
United States Electric Power Corporation common	307,931	15.0299	4,628,200.13	6.50	2,001,551.50
United States Electric Power Corporation warrants	94,372			2.125	200,540.50
United States Electric Power Corporation warrants	77,727			2.125	165,169.88
Accrued Income			25,000.00		
Total securities surrendered in exchange			4,853,200.13		2,592,261.88

[10] Ibid.

[11] Ibid. As stated previously, this accounting device of entering the cost of securities acquired at the original cost of securities exchanged when both groups of securities had a market value considerably below original cost, was frequently employed by the Founders management in exchange transactions. See infra, p. 2340.

b. Profit Recorded by Founders Companies through Transfer to Them by American Founders Corporation of Common Stock of United States & Overseas Corporation

Soon after the organization of the United States & Overseas Corporation in January 1929,[12] American Founders Corporation acquired 75,000 shares of the original issue of common stock at $10 a share.[13] In September 1929, The Harris Forbes Corporation, which was associated with the Founders Group in the sponsorship of United States & Overseas Corporation, made a public offering of 600,000 shares of common stock of the corporation.[14] Of this offering, 450,000 shares comprised a new issue by United States & Overseas Corporation, and the balance of 150,000 shares was obtained from the holdings of the sponsors.[15] The Harris Forbes Corporation paid to United States & Overseas Corporation for its 450,000 newly issued shares of common stock, $36 a share, a total of $16,200,000; and it paid to the sponsors for the 150,000 shares of original issue common stock, $20 a share, a total of $3,000,000.[16] The total cost to The Harris Forbes Corporation of the entire 600,000 shares was, therefore, $19,200,000, or an average of $32 a share. The Harris Forbes Corporation offered the stock to the public at $35 a share, a spread of $3 a share, or $1,800,000 on the 600,000 shares.[17] Despite the lower price paid by The Harris Forbes Corporation to the sponsors for their 150,000 shares, these sponsors, having acquired the stock at $10 a share, realized a gross profit of $10 a share or $150,000 in the aggregate.[18]

Of the 150,000 shares furnished by the sponsors, 37,500 shares came from the 75,000 shares originally acquired by American Founders Corporation.[19] But these shares did not come directly from American Founders Corporation. Immediately prior to the "take-down" of these shares by The Harris Forbes Corporation, American Founders Corporation transferred its entire 75,000 shares to four of the Founders companies at its cost price of $10 a share,[20] thereby forsaking an assured profit of $10 a share on 37,500 shares, or a total of $375,000. The 75,000 shares of United States & Overseas Corporation stock was not, however, transferred directly from American Founders Corporation to the other Founders companies but pursued the following course.

On September 17, 1929, American Founders Corporation sold the 75,000 shares of United States & Overseas Corporation common stock to the brokerage house of McKinley & Company at $10 a share.[21] The next day, McKinley & Company sold the same 75,000 shares to the four Founders companies at $10 1/16 a share.[22] Within three or four days

[12] Formed jointly by the Founders Group, The Harris Forbes Corporation, and the Deutsche Bank of Berlin. (Op. cit. supra, note 3, at 22110.)

[13] Id., Commission's Exhibit No. X3960.

[14] Id., Commission's Exhibit No. X3964.

[15] Id., at 25359–60.

[16] Ibid.

[17] Ibid.

[18] Ibid.

[19] Id., Commission's Exhibit No. X3926.

[20] Ibid.

[21] Id., Commission's Exhibit No. X3975.

[22] Id., Commission's Exhibit No. X3926.

subsequent to the receipt of these 75,000 shares by the four Founders companies, 37,500 shares were purchased from them by The Harris Forbes Corporation at $20 a share, thus enabling these companies to realize "profits" aggregating $370,874.50.[23]

This "profit" recorded by these four Founders companies cannot be distinguished without difficulty from an outright gift to them on the part of American Founders Corporation. It is true that in three of these four companies American Founders Corporation owned at the time a predominant interest; [24] but with respect to the fourth company, Investment Trust Associates, which realized $125,000 in profits,[25] not even this factor existed to cast light upon this act of generosity on the part of the American Founders Corporation.[26]

The immediate gain of $370,874.50 was not the sole benefit realized by the four Founders companies from the United States & Overseas Corporation stock acquired by them from American Founders Corporation. Following the sale to The Harris Forbes Corporation of the block of 37,500 shares, these four companies retained 37,500 shares additional at a cost of $10 1/16 a share. However, the activities of The Harris Forbes Corporation established a market price for the stock in the neighborhood of $35 a share.[27] Consequently, in addition to the realized profits of $370,874.50, there was an immediate unrealized appreciation on the stock retained by the four companies of $25 a share, or a total of $937,500, thus increasing to $1,308,374 the realized and unrealized profits on this block of 75,000 shares of United States & Overseas Corporation stock. The manner in which the unrealized profits were converted into "realized gains" during 1930 will now be related.

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[23] These transactions are summarized in the following schedule (id., Commission's Exhibit X3926) :

	Second International Securities Corp.	Received and sold by: United States & British International Co., Ltd.	American & General Securities Corp.	Investment Trust Associates	Total
Date received (1929)	September 18	September 18	September 18	September 18	
Number of shares received	20,000	15,000	15,000	25,000	75,000
Total cost at $10 1/16 per share	$201,250.00	$150,937.50	$150,937.50	$251,562.50	$754,687.50
Date sold (1929)	September 23	September 24	September 21	September 23	
Number of shares sold	10,000	7,500	7,500	12,500	37,500
Sales proceeds at $20 per share less tax	$199,400.00	$149,550.00	$149,550.00	$249,250.00	$747,750.00
Cost of sales	$100,156.25	$75,468.75	$75,468.75	$125,781.75	$376,875.50
Realized profits	$99,243.75	$74,081.25	$74,081.25	$123,468.25	$370,874.50

[24] Op. cit. supra, note 3, Commission's Exhibit No. X3405 (Schedule H).

[25] Investment Trust Associates received from McKinley & Company 25,000 shares, of which 12,500 shares were "taken down" by The Harris Forbes Corporation for a profit of approximately $125,000.

[26] American Founders Corporation itself owned no stock in Investment Trust Associates, but some of its subsidiaries owned small amounts. (Op. cit. supra, note 3, Commission's Exhibits Nos. X3402, X3407, and X3409.)

[27] Id., at 25359.

c. Method by Which Founders Companies Recorded Profits on Remaining United States & Overseas Corporation Stock

On September 8, 1930, The Public Utility Holding Corporation of America made a formal offer to exchange its stock for the common and Class A stock of United States & Overseas Corporation.[28] In exchange for each 10 shares of common stock of United States & Overseas Corporation, The Public Utility Holding Corporation of America offered a block of its own securities consisting of three shares of $3 preferred, five shares of common, and warrants to purchase seven shares of common.[29] For each 24 shares of United States & Overseas Corporation Class A stock, The Public Utility Holding Corporation offered five shares of its $3 preferred stock and warrants to purchase 24 shares of its common stock.[30]

Eight Founders companies, including the four companies which figured in the transactions recounted above, had in their portfolios a total of 75,000 shares of United States & Overseas Corporation Class A, and a total of 173,221 shares of common stock.[31] Partly because of the low price of $\$10\frac{1}{16}$ a share at which some of this stock had been acquired, as was recounted above, the entire block showed an unrealized profit, based on market prices, of approximately $930,000.[32] This sum the Founders management was apparently anxious to enter in realized profits accounts for the fiscal period ending November 30, 1930. At the same time the Founders management wished to effect the exchange for securities of The Public Utility Holding Corporation, in accordance with the exchange offer.

However, if the exchange of United States & Overseas Corporation shares for The Public Utility Holding Corporation shares were made directly by the respective Founders companies with The Public Utility Holding Corporation, this profit of $929,331.58 would not be reported as realized, for the accounting procedure regularly employed by the Founders companies in exchange transactions would have required that the value of the shares received be entered at the cost of the shares exchanged; that is, no gains or losses were recorded on exchanges. This practice previously had been effectively utilized by the Founders companies in order to avoid recording losses in numerous transactions where such use was at least questionable.[33] Application of this prac-

[28] Id., Commission's Exhibits Nos. X4108 and X3956.

[29] Ibid.

[30] Ibid.

[31] Id., Commission's Exhibit No. X3927.

[32] Ibid.

[33] A large number of such exchange transactions were effected in the last week of November 1930 by American Founders Corporation and United Founders Corporation. Two of these transactions were described in earlier chapters, to wit: (a) Exchange between American Founders Corporation and Founders General Corporation; cost entered at amount of original cost of securities exchanged, a figure $2,372,215 above market value at time of exchange. (See supra, p. 2306.) (b) Exchange between United Founders Corporation and American Founders Corporation involving United States Electric Power Corporation stock and American and Continental Corporation stock; cost entered at original cost of securities exchanged, a figure approximately $2,000,000 above market value at time of the exchange. (See supra, p. 2335.) In all, American Founders Corporation effected four such exchange transactions, in which it entered the book value of the securities acquired at a sum $5,871,381.24 greater

tice to the exchange of United States & Overseas Corporation stock for The Public Utility Holding Corporation stock would have meant that the latter would be valued at the cost of the former, and the unrealized market appreciation would thus not be reflected in the corporation's accounts. In order to record the $929,000 of profits, while at the same time making the exchange of United States & Overseas Corporation stock for the stock of The Public Utility Holding Corporation, the Founders management determined on this occasion to circumvent the operation of their regular accounting practice.

Accordingly, the brokerage firm of D. H. Silberberg & Company was again called in,[34] and a sale was made to it of all the United States & Overseas Corporation stock owned by the various Founders companies. On the same day, D. H. Silberberg & Company sold to the respective Founders companies equivalent amounts of The Public Utility Holding Corporation stock.[35] David H. Silberberg, testifying with respect to these transactions, acknowledged:[36]

> I was in effect making the exchange and being paid a commission [$15,013.81] for making the exchange.

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than the market value at the time of exchange. United Founders Corporation effected eight such exchanges, entering the book value of the securities at a sum $8,303,523 higher than the market value at the time of exchange. In this manner, these two top Founders companies avoided reporting to their stockholders in 1930 losses aggregating $14,174,904. In their income-tax returns for the year 1930, however, these companies deducted the entire sum of $14,174 904 as investment losses. (Op. cit. supra, note 3, Commission's Exhibits Nos. X3830 and X4274.) On this subject Lawrence F. Carron, treasurer of the Founders companies testified (id., at 26720):

> "Q. Now this Exhibit 4274 shows that the sum of the losses taken in the income-tax returns was $14,000 000. My accountants advise me that none of these losses were recorded on your books. I take it that is not disputed.
>
> * * * * * * *
>
> "I mean, Mr. Carron, you know and Mr. Conkling knows that this is not reflected in the Profit and Loss Account.
>
> "A. The difference between those securities exchanged? That is right."

[34] It will be recalled that the firm of D. H. Silberberg & Company figured in another transaction, previously discussed (see supra, 2280), in which United Founders Corporation sought to circumvent the principle of elimination of intercompany profits in its consolidated statement.

[35] The details of these transactions are shown in the following schedule (op. cit. supra, note 3, Commission's Exhibit No. X3927):

	Shares of United States & Overseas Corporation Delivered				
	Class A	Common	Cost	Transfer expense [a]	Total cost
American Founders Corp	75,000		$750,000.00	$9,187.50	$759,187.50
American Founders Corp		10,000	150,000.00	1,225.00	151,225.00
United Founders Corp		73,081	1,394,453.20	8,952.42	1,403,405.62
Second International Securities Corp		18,995	290,384.38	2,326.89	292,711.27
American & General Securities Corp		15,300	241,931.25	1,874.25	243,805.50
International Securities Corp. of America		9,945	219,971.25	1,218.27	221,189.52
United States & British International Co., Ltd		15,400	243,856.25	1,886.50	245,742.75
Investment Trust Associates		22,500	275,780.75	2,756.25	278,537.00
Founders Associates		8,000	133,475.00		133,475.00
Totals	75,000	173,221	3,699,852.08	29,427.08	3,729,279.16

(Footnotes 35 and 36 continued on p. 2342)

Lawrence F. Carron, treasurer of several of the Founders companies, conceded: [37]

Yes; we made the sale to take the profit.

The testimony of David H. Silberberg with respect to the mechanics of the exchange was as follows: [38]

Q. On September 26, Mr. Silberberg, you bought 173,221 U. S. & Overseas with warrants for a sum in excess of $4,500,000, including 75,000 A shares with warrants, and you sold on the same day Public Utility Holding Company units preferred and warrants, for a sum in excess of $4,500,000. How did you come to go into these two transactions; who asked you, and what assurance were you given, and how were they financed?

A. Apparently the transactions, as indicated on that schedule, were made on the same day and were cleared without any financing, as far as I know; just an exchange of checks and bills and on the basis of an exchange offer, I believe, which was being offered by Public Utility Holding Company for U. S. & Overseas stock, and we did the transaction as indicated there.

Q. In other words, instead of the U. S. & Overseas shares being offered in exchange for the Public Utility Holding Company shares directly, they went through you and you were in effect making the exchange?

A. I was in effect making the exchange and being paid a commission for making the exchange.

* * * * * * *

Q. Mr. Silberberg, would you not make an exchange for your customers without a commission? Why did you receive a commission on this transaction?

A. I might be willing to make exchanges without a commission, but I am not averse to receiving one if one is offered.

Q. Was there not some reason for giving you a commission on this transaction?

A. The trouble and time taken up in making the transaction.

	Shares of The Public Utility Holding Corporation of America Received					Profit recorded (loss)
	Units	$3 Pfd.	Common	Warrants	Total proceeds	
American Founders Corp		15,625		75,000	$954,296.88	$195,109.38
American Founders Corp	1,000				216,125.00	64,900.00
United Founders Corp	7,308.1				1,579,463.11	176,057.49
Second International Securities Corp	1,899.5				410,529.44	117,818.17
American & General Securities Corp	1,530				330,671.25	86,865.75
International Securities Corp. of America	994.5				214,936.31	(6,253.21)
United States & British International Co., Ltd	1,540				332,832.50	87,089.75
Investment Trust Associates	2,250				486,281.25	207,744.25
Founders Associates		2,400	4,000	5,600	133,475.00	
Totals	16,522.1	18,025	4,000	80,600	4,658,610.74	929,331.58

[a] Transfer expense comprises:

Commission paid to D. H. Silberberg & Co	$15,013.81
Taxes	14,413.27
Total	29,427.08

[36] Id., at 25243.

[37] Id., at 26603.

[38] Id., at 25240 et seq.

Q. And the taking of title?

A. The time.

Q. And probably the question of the fact you actually took title; is it not true it went through the form of your taking title?

A. That is correct.

Mr. Carron, when questioned as to the apparent inconsistency between the procedure followed in this exchange, where a profit was at stake, and the procedure followed in other exchanges, where losses were involved, testified: [39]

Q. Here we have something that came up to Founders in an identical or practically the same way that these U. S. E. P. exchanges came up. You were acquiring the securities of an affiliate in which you had a very, very substantial interest, if not controlling interest; you were exchanging other securities for it. The transaction in the case of U. S. Electric Power was recorded as an exchange, and the cost of the general portfolio was taken to be the cost of the U. S. Electric Power, no profit and no loss being recorded in the exchange. That is correct, Mr. Carron?

A. Right; and they were taxable losses for tax purposes.

Q. And you took them for tax purposes?

A. Yes, sir.

Q. So that your books of account and your reports to stockholders varied from your tax report for that year?

A. In that respect.

Q. Now, when you come to your Public Utility Holding Corporation exchange for U. S. and Overseas, in order to record a tax profit you ran it through as a sale of U. S. and Overseas and a purchase of Public Utility Holding Corporation; that is correct?

A. Right. We sold the U. S. and Overseas.

Q. And the effect was identical as though you had made an exchange so far as what you received for what you disposed of was concerned?

A. The eventual acquisition of what we sold through Public Utility Holding stock; right. The mechanics of acquiring that Public Utility Holding stock was entirely different.

Q. But when you came to this transaction you did record a profit?

A. Yes.

Q. And you carried that profit over onto your reports to the stockholders?

A. Right.

Q. Although there was no consistency between your tax reports and your reports to stockholders so far as losses were concerned; is that right?

* * * * * * *

A. I think everything was consistent in the exchange of securities on the acquisition of U. S. Electric Power shares. We did not consider that there was a sale of those securities. It was just a transfer of one asset to another. When you are in process of acquiring a large interest, probably a control interest, a permanent interest in a large company, such as we were, as distinguished from an actual sale of a security, as we sold the U. S. and Overseas—

Q. But didn't you adopt the mechanics, Mr. Carron, of making a sale in the case of U. S. and Overseas, just so that you would arrive accounting-wise at a different effect in accounting without violating a principle?

A. Yes; we made the sale to take the profit.

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[39] Id., at 26601 et seq.

6. NONDISCLOSURE THAT MORE THAN A MAJOR PART OF THE PUBLISHED INVESTMENT PROFITS OF INTERNATIONAL SECURITIES CORPORATION OF AMERICA WERE SECURED THROUGH VIOLATIONS OF THE PROVISIONS OF ITS TRUST INDENTURES, BYLAWS, AND AVOWED INVESTMENT POLICY

International Securities Trust of America (later International Securities Corporation of America), the oldest of the investment companies which comprised the Founders Group, and the base upon which the entire Founders structure was reared, repeatedly proclaimed its conservative policies and the unusual protective features with which it safeguarded the funds entrusted to it by its stockholders. Its Declaration of Trust (September 7, 1921) contained restrictions upon the type, geographical distribution, and relative proportions of the securities in which the trustees might invest.[1]

These restrictions were amplified in the amended Declaration of Trust (May 25, 1923) by additional provisions among which were the following:[2]

> 1. * * * The trustee shall not use the funds of this trust in connection with nor engage the trust in any enterprise involving promotion, business management or underwriting.
>
> 2. * * * No securities shall be purchased * * * unless:
>
> (*a*) Reliable information shall be obtainable with respect to the history, management, assets, earnings, and income of the governmental authority, corporation, or organization issuing such securities;
>
> (*b*) Unless the history of the nation or country in which such securities shall have originated shows financial stability and recognition of private rights; and
>
> (*c*) The governmental authority, corporation, or organization issuing or guaranteeing such securities shall have been established for a period of at least four (4) years.

These investment restrictions were widely advertised and continuously stressed by the Founders management in seeking to induce investors to purchase the securities and bonds of International Securities Corporation of America. By dint of constant repetition they served to create in the popular mind an aura of solidity and conservatism about the Founders companies. With respect to the publicized policies of the Founders management, William R. Bull, for-

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[1] Public Examination, American General Corporation, et al., Commission's Exhibit No. X3425A. Paragraph 16 of the Declaration of Trust provided in part:

> Of the total available assets of the trust, not more than 60% may be invested in securities originating in the United States, not more than 45% may be invested in securities originating in England, and not more than 35% may be invested in securities of any other country, said amounts to be distributed over various classes of securities in the different countries as may be further provided in the bylaws of the trust.
>
> When $1,000,000 has been paid into the treasury of the trust and invested in bonds, notes, and stocks of all kinds said investments must be so distributed that on an average not more than one-fourth of one percent of the entire assets are invested in any one security.
>
> Not more than 10% of the total assets of the trust may, at any time, be invested and held in securities representing any distinct class of business or industry in any one country.

[2] Public Examination, American General Corporation, et al., Commission's Exhibit No. X3426, Art. IV.

merly chairman of the board of trustees of International Securities Corporation of America, testified:[3]

Q. You spoke of the fact that the securities were being sold on the basis somewhat of the English experience, and following that, Mr. Bull, you advertised in connection with the International Securities Trust certain features, which I take it you thought were the same as the English trusts. Among these were that the corporation furnishes, purchases, and holds a wide variety of seasoned, marketable securities. This feature of seasoned, marketable securities was an argument that you used over and over again, was it not, in connection with the International Securities Trust?

A. We used it from time to time. I don't know how often. I know we used it frequently.

Q. And you pointed out to the public from time to time that you would take only seasoned securities, that was the fact in International Securities Trust?

A. I think so; yes.

Q. You also pointed out another feature of the investment trust was that there was diversification and you got the advantage of having a vast amount of securities. So that every investor bought not a single security, but he was protected by having diversification; he bought a little piece of diversification?

A. That is correct.

Q. That was considered one of the substantial advantages that the investment trust had to offer, was it not?

A. Yes.

Q. You also pointed out in connection with International Securities Trust that no funds may be invested in any new or unproven security—seasoned securities only—and that the trust may not engage in promotion or business management—

A. That is correct.

In the annual report to the shareholders of International Securities Corporation for the year ending November 30, 1925, Mr. Bull, as chairman of the board of trustees, wrote:[4]

The use of the term "Investment Trust" in the United States has been so abused in recent years that it is necessary to emphasize that International Securities Trust of America is one of the few organizations in America which has the undoubted right properly to use the term.

International Securities Trust of America is the first general investment trust established in the United States and is patterned closely after the British investment trusts, which have been successful over a period of approximately more than half a century.

* * * * * * *

There is now conclusive evidence from every part of the country that the Trust, operating on such demonstrated and accepted principles as have been briefly outlined in this report, is the only investment trust of its kind in the United States. An investment trust of this type should offer to the investing public a form of security which, due to the methods adopted of investing its funds, to the construction of its bond and share capital, and to the resulting investing equities is unique, and whose full equivalent cannot be found in any other form of institution.

When International Securities Trust of America was transformed into a corporation under the laws of Maryland in 1927, the provi-

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[3] Id., at 22044 et seq.

[4] Id., Commission's Exhibit No. X3457 (pp. 5, 6. 11).

sions formerly incorporated in its Declaration of Trust were embodied in substantially identical form in the bylaws of the corporation.[5]

International Securities Corporation of America's restriction to diversified and seasoned securities continued to be stressed prominently by the management, as the Founders system expanded. When International Securities Corporation of America in 1927 brought out an issue of debentures through Harris, Forbes & Co., the offering circular proclaimed to the investing public:[6]

> The corporation will not invest its funds in securities of any corporation or organization unless such corporation or organization or its predecessor, shall have been established for at least four years prior to such investment.

Provision to this effect was also formally incorporated in the indenture between International Securities Corporation of America and the debenture trustee, Guaranty Trust Company of New York.[7]

These "safeguards for the investor" continued to be emphasized and re-emphasized in the advertising literature of the Founders companies throughout the entire period of growth. As late as 1929, Harris, Forbes & Co., which acted as bankers for many of the Founders companies, in an elaborate brochure entitled "The American Founders Group of Companies" circulated among the investing public, stressed the "safeguards for the investors" contained in the indentures of International Securities Corporation of America and other of the various Founders companies. Under the heading "Safeguards for the Investors," it was stated:[8]

> There are many precautions which have been taken to prevent any such dissipation [of the funds of the investor], remote as such a contingency may seem. Perhaps the most far-reaching are provided in the Indentures which secure the debentures. Three of the companies named * * * have incorporated in their indentures rules and regulations as to their investments and as to the amount of equity which must be maintained, and provisions for reports to be rendered to the Trustees, so that the purchasers of the senior securities may satisfy themselves that the regulations and provisions have been carried out. A penalty is provided, i. e., that of default, under the indenture and the acceleration of the maturity of the debentures, in case the provisions are not carried out. The Trustee in each case is a strong bank or trust company.
>
> The faithful carrying out of the provisions of the Indenture for the benefit of the debenture holders obviously similarly benefits the holders of the preferred and common shares.
>
> There are additional investment restrictions in the By-Laws of the companies and certain regulations in the resolutions of their Boards of Directors.

The Founders management, while stressing and reiterating to the public the special protection afforded to investors by the investment restrictions contained in International Securities Corporation of America's declaration of trust, bylaws and indentures, was deliberately paring away these safeguards in the new Founders companies

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[5] Reply to the Commission's questionnaire for International Securities Corporation of America, Pt. I, Exhibit C.

[6] Op. cit. supra, note 2. Commission's Exhibit No. X3401 (G-1).

[7] Id., Commission's Exhibit No. 3401 (I-3).

[8] Id., Commission's Exhibit No. X4336.

which were being launched with accelerating frequency from 1926 until the end of 1929. In this regard, Louis H. Seagrave, president of American Founders Corporation, testified: [9]

Q. Now with the formation of Second International and again in the formation of U. S. and British, you departed from the principle that had likewise governed and was advertised to govern International Securities Trust up to this time, namely, these companies could invest in new enterprises. They were not restricted as International was under its charter to seasoned securities, securities that had a certain number of years' existence?

A. That is true. We did make a departure but it was a deliberate one and intended deviation from the restrictions which prevented International Securities Trust from doing so.

* * * * * * *

Q. The fact is that you started off with International and advertised that it had certain principles and restrictions; one of them was that it could not go in for promotions or underwritings; another one was that it could not invest in securities except such as were seasoned, and the third was that it was not connected with any house of issue.

Now, up to this point in 1928 these principles have been laid aside in the case of these operating companies.

A. That is correct.

Q. Now further in 1928—a little later in 1929, another company was formed. That was the American and General Securities Corporation. Is that correct?

A. I believe that is correct.

Q. What was the purpose of forming American and General?

A. Well, we had sponsored several companies to be brought out. We had also been somewhat persuaded by some British friend whom we came to know earlier in the year and by our own studies that an investment company as such ought not to be too large.

Secondly, we found that even in the restrictions that we had laid aside in the case of Second International. U. S. and British, a few of them we felt were still undesirable, and there were some few additional regulations in the restrictions that had governed the previous companies.

Q. What were the restrictions that you found you had to cast aside in forming American and General?

A. Well, I haven't any of the documents here with me and therefore I am not able to spell out the rather elaborate differences, but I think they are at least four or five, one of which was the ability to invest any amount of funds in a new enterprise, and I believe another was the expansion of the ability to underwrite.

Not content with increasingly whittling away these restrictions in the new Founders companies, the Founders management, commencing in 1928, began to disregard the restrictions contained in the indentures, bylaws, and repeatedly proclaimed policies of International Securities Corporation of America itself.

In point of fact, approximately 65% of the total amount of realized investment profits of International Securities Corporation of America during the prosperous years of 1928 and 1929 was derived from transactions involving violations of these restrictions. Needless to say, no intimation of this fact was conveyed by the management to

[9] Id., at 22080 et seq.

the investment company's stockholders or the investing public, and no qualifications were noted by the independent public accountants who audited and certified the company's financial statements.

The details of the transactions in which International Securities Corporation of America recorded these "illegitimate" profits (many of which were not profits at all, as has been demonstrated) have been set forth in preceding sections. All of these transactions violated the provisions requiring that the corporation should not invest its funds in securities of any corporation or organization "unless such corporation or organization, or its predecessor, has been established for at least four years prior to such investment." In all, there were four such transactions as follows:

(*a*) Profits of $1,681,445 realized by International Securities Corporation of America in 1929 from the exercise of options for the purchase of stock by the newly formed United Founders Corporation.[10]

(*b*) Profits of $1,166,960.54 realized by International Securities Corporation of America in 1929 from the purchase and sale of stock of the newly organized The Public Utility Holding Corporation of America.[11]

(*c*) Profits of $186,000 realized by International Securities Corporation of America in 1928 and 1929 from the purchase and sale of the stock of the newly organized United States Electric Power Corporation.[12]

(*d*) Profits of $3,138,151.59 realized by International Securities Corporation of America in 1928 and 1929 from the purchase and sale of the stock of the newly organized Investment Trust Associates.[13]

Of the $6,172,557.13, which these four items aggregate, $877,347 was realized in 1930,[14] and the balance of $5,295,210 in 1928 and 1929.[15] Total realized profits of International Securities Corporation of America in 1928 and 1929 equaled $8,245,621,[16] of which the $5,295,210 gained in violation of the reinvestment restrictions constituted approximately 65%.

It will be recalled that the sum of $1,681,445, listed as item "a" above, was entered in its income account by International Securities Corporation of America through the exercise of options granted to the Founders companies at "inside prices." Louis H. Seagrave, when examined as to whether these options were not conceived as a device to enable International Securities Corporation of America to circumvent the much publicized restrictions and "safeguards" contained in its bylaws and indentures, testified:[17]

Q. Now, part of that option procedure was a matter of design, so as to enable International to take a profit in a security in which it could not invest, is that not so? United Founders was not a seasoned security, therefore International could not invest in it?

A. I think that is a fairly accurate statement. International certainly was not in a position to buy and own the shares of United Founders Corporation,

[10] For details see supra, p. 2258.
[11] For details see supra, p. 2268.
[12] For details see supra, p. 2340.
[13] For details see supra, pp. 2276 et seq.
[14] Op. cit. supra, note 2, Commission's Exhibit No. X3732.
[15] Ibid.
[16] Ibid.
[17] Id., at 24678-9.

and yet there was a strong feeling throughout the organization that International ought not to be the only company of the group who was not privileged to buy any of the shares of new companies within the group, and this, in effect, did give them an opportunity of making a profit without actually investing their money.

Q. On the other hand, Mr. Seagrave, if International had attempted to take down an allotment when the market went the other way, it would have been promptly stopped by any minority stockholder that desired to bring an injunction suit, would it not?

A. Without being a lawyer I still think, as a layman, that probably would be true.

The reasoning advanced by the Founders management in justification of the dealings by International Securities Corporation of America in the stock of Investment Trust Associates (item "d" above) constitutes still another example of the tendency on the part of the management and its accountants, a tendency noted and commented on in relation to several of the transactions previously described,[18] to accord perfunctory observance to mere form, while completely ignoring substance. Investment Trust Associates, which was acquired by the Founders Group in November 1928, had been organized four years and two months previous to that time by Christopher F. Coombs (one of the organizers of the Founders system) as a personal holding company for the securities of himself and his family.[19] Mr. Coombs, in 1928, it was claimed, was in the process of transferring all the assets from this company to another of his companies, Investors General Corporation.[20] The Founders Group was at that time contemplating the formation of a new investment company, and allegedly because some of the Founders officers were attracted by the name of the company Mr. Coombs was preparing to abandon, they sought, and obtained, permission to take over "the name and the shell of an organized trust." [21]

Although the corporation was so completely metamorphosed upon its acquisition by the Founders Group, as to capital structure, personnel and the nature of its business, as to constitute an entirely new and

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[18] See testimony of Lawrence P. Carron and W. H. Conkling concerning the "mock" sale to D. H. Siberberg & Company to avoid elimination of intercompany profit (supra, p. 2280); see testimony of Founders officers and W. H. Conkling relative to nonconsolidation and nonpublication of the accounts of Founders General Corporation (supra, p. 2296); see account of mock sale to D. H. Silberberg & Company in order to record profit on exchange for The Public Utility Holding Corporation stock (supra, p. 2335).

[19] Op. cit. supra, note 2, at 22094, 22978, et seq.

[20] Id., at 22978 et seq.

[21] Louis H. Seagrave testified (id., at 22096):

Q. Now, tell us the circumstances under which that became an affiliate of the Founders Group? Why was it?

A. Well, this was a company, which, for reasons best known to himself—I don't know what they were—Mr. Coombs was about to relinquish. In other words, he had formed some other company, or something of the kind, and transferred the assets. At that time we were considering the formation of a company to specialize in equity securities. There was a good deal of demand by that time, among the dealers for a company which confined itself largely to equities.

The term Investment Trust Associates rather appealed to some of us and we asked therefore if we could take over the company, what its assets were, and it developed that he was in the process of transferring the assets out, so that he did not want to sell us the company, but he was perfectly willing to let us take over the company after he had transferred the assets out and continue its name, so that what we took over was, in lieu of the company with its assets, after the assets had been distributed, the name, and that was all.

Q. The name was substantially all that was taken over?

A. Yes; the name and the shell of an organized trust.

different company, the Founders management, seizing upon the circumstance that the original company had been incorporated by Mr. Coombs four years and two months prior to the acquisition by the Founders Group, decided that its securities were eligible for investment by International Securities Corporation of America despite the "four-year" restriction. As stated by Louis H. Seagrave: [22]

> There was a feeling then already that that restriction of International's was a detriment to it, and here was a case where a technical compliance—and I will admit only a technical one—was found in Investment Trust Associates.[23]

W. H. Conkling, member of the firm of Loomis, Suffern & Fernald, who were the auditors for International Securities Corporation of America, in explaining why the published financial reports of the corporation, as certified by Loomis, Suffern & Fernald, contained no reference to, or intimation of, these profits, despite the fact that the transactions substantially violated the bylaws and indentures, and were therefore extraordinary and nonrecurring in character, expressed the view that "* * * if the directors of the company authorize such transactions I don't think that the accountants can do much about it." Mr. Conkling's testimony was as follows: [24]

> Q. Now, we have a situation here that I would like to get your views very briefly on, Mr. Conkling. There were several instances where International Securities Trust of America and later International Securities Corporation of America took profits in certain transactions aggregating about $6,000,000. The transactions were in the securities of companies that had not been in existence for four years. I think. included in these transactions, is one that was in a company that had been in existence for four years technically but sold out all of its property and started over again in what was substantially a new business. But for the purposes of my question, here is International Securities Corporation of America investing in securities of other companies in the group which were not seasoned according to their charter and bylaws and therefore it had no authority to invest in those securities. It made a profit in every

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[22] Id., at 22974.

[23] This legalistic construction of the "four-year" restriction flouted the obvious purport and intent of this restriction, when read in the context in which it was embodied in the corporation's bylaws. A reading of this context makes it clear that the purpose of the restriction was to assure investment in seasoned securities of companies concerning whose history, management, assets, and earnings, reliable information was obtainable. Obviously, any such information obtained with respect to Investment Trust Associates in 1928 would merely have established that it was a newly created organization which did not meet the requirements of the bylaws. Sec. 17 of the bylaws, so far as applicable, states (Reply to the Commission's questionnaire for International Securities Corporation of America, Pt. I, Exhibit C):

> The following rules and regulations shall control the Board with reference to securities:
> (a) Reliable information shall be obtainable with respect to the history, management, assets, earnings and expenses of the governmental authority, corporation, or organization issuing such securities;
> (b) The history of the nation or country in which such securities shall have originated must show financial stability and recognition of private property rights;
> (c) The governmental authority, corporation, or organization and/or their predecessors (except the predecessors of governmental authority) issuing or guaranteeing such securities must have been established for a period of at least four (4) years prior to such investment.

For detailed testimony of Louis H. Seagrave, supplemented by statements of Royal E. T. Riggs, counsel to the Founders companies, with respect to this transaction, see Appendix C, infra.

[24] Op. cit. supra, note 2, at 26757 et seq.

one of those transactions, so that nobody was damaged by the transaction itself in International Securities Corporation of America; but that situation was one where obviously it was a nonrecurrent situation in more ways than one: It couldn't possibly recur, or presumably couldn't and shouldn't recur. I take it those situations should clearly have been set up separately, shouldn't they?

A. If you have definite assurance that it is a nonrecurring transaction.

Q. Well, I thought we would have no difficulty on that one point.

A. Of course, my difficulty as an accountant, as I am sure many other accountants will agree, is to determine what is a nonrecurring transaction.

Q. I don't think we need spend much time on that, do we, Mr. Conkling?

A. That is my difficulty in answering your question.

Q. Here is an unauthorized investment by International Securities Corporation. The only thing that makes it not involve the corporation in difficulties is, they profited by violating their charter and bylaws. Had the market gone against them, they needn't have taken it up, because the people to the other side of the transaction knew that it was an unwarranted transaction, that they couldn't be compelled to take it. A stockholder could probably have enjoined the whole thing. Therefore this is clearly a nonrecurrent transaction if there ever was one, isn't it?

A. Yes.

Q. That must have been shown mustn't it, by any sound principles of accounting, separately from other accounts of income?

A. That is the way we look at it today; yes.

Q. Was there any possibility of looking at it any other way?

A. I am not sure that the accountant can determine that that kind of transaction was a transaction which the corporation should not have entered into, if it was authorized by the board of directors.

Q. That is a question that I would also like to ask. Suppose you had the situation, International Securities purchasing say Public Utility Holding Corporation, then newly incorporated; would it not be part of your function, or would it be a part of your function as an auditor to have known that bylaws and the restrictions imposed by the company upon investments, to see whether that was an authorized transaction?

A. We are supposed to know what the bylaws and charters provide, but if the directors of the company authorize such transactions I don't think that the accountants can do much about it.

Q. You realize, Mr. Conkling, that I am not seeking in these general questions particularly to lay any blame or praise or anything, other than to find out what is feasible to protect the investment public money.

A. Yes; I understand that.

Q. I take it an audit includes the reading of the minutes of every meeting, doesn't it?

A. Yes; that's right.

Q. And also includes an examination of the bylaws and the charter?

A. Yes; whoever is in charge of the engagement is supposed to review and make notes with respect to the provisions of the charter and bylaws. That is a part of an audit.

Q. And the indentures of the corporation?

A. Yes; generally familiar with the indentures of the corporation.

Q. And the restrictions on investments contained in those indentures?

A. Yes.

Q. How about offering circulars to the public? In your view, would an accountant be obligated to look through those?

A. I think not.

Q. How about the representations made in reports, although I take it that is not such a great danger today; people don't put advertising matter in reports to the extent that they used to, do they?

A. No; they don't, to the extent that they used to; but as far as representations made in reports, sometimes we check over the figures to see that any figures given are in accordance with the statements that the company is also issuing, but so far as the statements themselves which are made, we don't always review those; sometimes we never see them. Recently it has become more the practice for us to see some of those statements, but not always do we see them.

Franklin Bowman, member of Haskins & Sells, the accounting firm whose name appeared on International Securities Corporation of America's reports as "Consulting Accountants," expressed views similar to those of Mr. Conkling, but conceded that "maybe there should be some mention made of it": [25]

Q. The records disclose that there were certain profits made by International Securities Corporation of America from the sale of securities of companies affiliated with the Founders Group. Some of these companies were newly created companies. The International Securities Corporation could deal only in seasoned securities, that is, of companies that had been in existence for a certain number of years. These transactions resulted in profits. Shouldn't you say that those profits should be separately indicated in the profit and loss account?

A. You mean because they were profits on sales of affiliated companies, or because they were nonpermissible?

Q. Nonpermissible transactions.

A. Well, if they were nonpermissible, and the accountants discovered that fact, they would take it up with the management.

Q. You see, it would not have made any difference to the company, because the company had a profit, but it would have made a difference to the stockholders, because they might have assumed that these were regular permissible and recurrable profits. As a matter of fact, being nonpermissible, they were the strictest kind of nonrecurring profits, were they not?

A. Well, when you talk about nonrecurring profits in the sale of securities, you are getting in pretty deep. Profits and losses in the sale of securities, in themselves, may be more or less nonrecurrent.

Q. But, in any event, they were nonpermissible profits. Should that not have been indicated?

A. I doubt whether at that time any accountant would have considered it necessary, in view of the fact that they made a profit; but as you put it now, I expect maybe there should be some mention made of it.

7. TESTIMONY OF THE OFFICERS OF THE FOUNDERS SYSTEM CONCERNING SUMS TOTALING APPROXIMATELY $50,000,000 PLACED IN INCOME ACCOUNTS OF FOUNDERS COMPANIES ON THE DISPOSITION OF THE SECURITIES OF ALLIED COMPANIES

In the foregoing sections there was furnished a detailed itemization of the greater part of the sums totaling $46,683,319 placed in profits accounts of the Founders companies in connection with the

[25] Id., at 26848–9.

purchase and sale of the securities of one another and of allied companies during the period 1928–1930.[1]

It will be recalled that the total reported profits of the Founders companies from all investments during the period 1928–1930 equaled $43,289,733;[2] that the difference between this sum and the $46,683,319 of "profits" from intercompany transactions represented a loss of $3,393,586 on general portfolio securities;[3] that, in consequence, every dollar recorded as "profits" by the Founders companies for the three-year period was derived from dealings in the securities of Founders companies or their affiliates.

It will be recalled, too, that although the "post-crash" year of 1930 is included in this composite, both in 1928 and in 1929 intragroup dealings accounted for an impressive portion of the entire amount entered as profit by the principal Founders companies in each of those years. It was shown, for example, that in 1928 the "profits" recorded by International Securities Corporation of America, Second International Securities Corporation, and United States & British International Company, Ltd., from transactions in securities of companies wholly within the Founders Group equaled 43% of all investment profits reported for that year by this group of companies.[4] In the same year, 1928, the sums recorded as profits by American Founders Corporation from transactions in securities of companies within the Founders Group equaled 76% of all investment profits reported by it for that year, while in 1929 the proportion of "profits" from intragroup transactions to all profits rose to 95% for American Founders Corporation and five of its subsidiary companies.[5]

During the course of public examinations conducted before the Commission with respect to the activities of the Founders system, various of the former principal officers of the Founders Group were interrogated in regard to the intercompany dealings described in the foregoing sections.[6]

While in some instances these officers disagreed strongly with contentions advanced by the Commission's staff, such disagreements were rarely addressed to the accuracy or authenticity of the facts and figures adduced, but were almost entirely confined to the inferences to be drawn from these facts and figures. The testimony of some of these officers with respect to intercompany dealings is set forth at this time in some detail, in order that the contentions, arguments, and defenses of those who were responsible for the conduct of these companies which controlled approximately one-half billion dollars of the money

[1] Details have not been set forth for a number of minor intercompany dealings resulting in sums treated as profits, totaling approximately $7,000,000. These transactions are listed in Appendix R (Public Examination, American General Corporation, et al., Commission's Exhibit No. X3732) and in form follow one or another of the patterns of the various transactions discussed in detail in this section.

[2] Public Examination, American General Corporation, et al., Commission's Exhibit No. X3732. See discussion supra, p. 2220.

[3] Ibid.

[4] Ibid.

[5] Ibid.

[6] This testimony also dealt in some detail with the itemized schedule prepared and placed in the record by the staff of the Commission (Appendix R), in which these profits are summarized.

of the investing public,[7] the greatest portion of which was lost to the investors,[8] may be evaluated.

a. Testimony of Erwin Rankin

Erwin Rankin was, during the period 1928–1930, the president of American & General Securities Corporation, a vice president of American Founders Corporation, and a director and member of the executive committee in three other Founders companies: Second International Securities Corporation, Investment Trust Associates, and American and Continental Corporation.[9] The principal value of Mr. Rankin's testimony, however, derives from the fact that he was one of the chief executives in control of the investment and research division of American Founders Corporation.

It will be recalled that the importance and excellence of the investment and research division of American Founders Corporation were constantly emphasized by the Founders management. Its large staff of expert personnel and its scientific methods were described in detail time and again in the Founders advertising and published statements; and it was stated that the Founders companies' remarkable records of achievement and their "successful international cyclical trading operations" were attributable to the excellence of this division.[10]

Reflecting these reiterated claims, an article entitled "Service by American Founders" published in "The United States Investor" fol-

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[7] See supra, p. 2220.

[8] See note 13, supra, p. 2222.

[9] Public Examination, American General Corporation, et al., Commission's Exhibit No. X3762.

[10] Typical of many of these statements is the following quotation from the annual report to the stockholders of American Founders Corporation for the fiscal year ended November 30, 1926, signed by Louis H. Seagrave, president (id., Commission's Exhibit No. X3465):

> It has been the desire of the Trustees to build up an investment organization second to none in the world, with facilities for immediate examination and report concerning investments of every character in every stable country. The Trust has made great strides throughout the past year in setting up such an organization, and 46 officers and employees are now engaged in investment analysis or research.
>
> Many additional banking contacts have been made abroad, new international investment markets have been entered, and the personnel employed in the New York office of the Trust for the analytical appraisal and operating divisions has been increased. The economics division has been separately organized. Its function is to conduct wide research and watch for securities out of line by country, commodity and industry, and the consequent opportunities for buying at attractive price levels.
>
> The economists of American Founders Trust study the general situation of the investment market in each country under consideration, examining such factors as interest rates, investment levels, political conditions, commercial conditions, commodity values, and foreign exchange rates. They follow the fortunes of important industries, both from a national and an international standpoint. Leaving the examination of particular stocks to the analysts, they call to the attention of the Investment Committee markets where current price levels offer probable opportunities for investment, or point out conditions indicating future decline.
>
> The analytical division includes the following sections, each under the direction of an analyst intimately familiar with the region: American Securities, British and General, Central European, Western European, Scandinavian, South American, Oriental.
>
> In their particular field these specialists follow general trends of security prices and analyze specific securities, so that they can assist the Investment Committee in determining what to buy or sell. They have had wide experience with foreign securities, and a number of them are natives of the country whose securities they examine.
>
> The Trust maintains correspondent banking relations with 38 strong institutions in 16 countries, through which foreign investment purchases are made. With few exceptions, each is the leading bank in its respective country, and most of them are correspondents of the large New York banks.

lowing the market crash of October 29, 1929, and thereafter reprinted and circulated, stated: [11]

Several times, during the past year, the statement has been made by some investment trust or financing company that it uses "Investment Service furnished by the American Founders Corporation." That phrase is becoming so familiar as to acquire something in the nature of a slogan. It indicates belief on the part of a number of investment organizations that this service has particular merit. Well, that service played a very large part in the conduct of American Founders Group, during these trying experiences in the stock market, just as it does at all other times. To this service, and to the important fact that the American Founders group operates on an international basis, belongs the principal measure of credit for the substantial amount of funds ready for making advantageous purchase of securities, and for the exact knowledge which the management had of what to buy and when to do so. The series of stock market developments which represented a cataclysm for so many people, were to the American Founders group scarcely more than the normal incident in their scheme of operations.

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THE "SET-UP"

One can get a better understanding of all this by a glance at the "set-up" of the organization. Of course, the American Founders Corporation has officers, directors, and committees. So do the British investment trusts, which even the critics of our American trusts are inclined to hold in high regard. To be perfectly frank, the weakness of British trusts in recent years has been that their set-up has included little more than this. They have operated in an international way, but they have relied mainly upon the knowledge and the contacts of individual directors for shaping their affairs in any particular market. Thus, one director would know Japan and have his contacts there, another would be equally well situated as regards the Balkans, and a third as regards South America.

The American Founders Corporation has directors with international contacts, but its operations are based upon the experience and the contacts and the research of a much larger body of men. In round figures, the corporation has an operating expense of $1,000,000 a year. Not all of it is the result of research and investment expense, but much of it is due to those items. The men who have built the big structure which the American Founders Corporation and its associated companies now represent, had more than the normal amount of human courage when they created so much of an organization, but the hundreds of millions of resources which are invested largely upon the research and the judgment of this organization, gives some idea of the confidence which this organization inspires. * * *

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A BUSY DAY

The last fortnight or so has seen the value of this organization tested by the most trying kind of a stock market. It came through the test as successfully in America as it had previously come through similar tests in Belgium, France and

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[11] Id., Commission's Exhibit No. X3842. The article was published under date of November 9, 1929, has been set forth in full in Appendix Q, infra.

Germany. It had been in contact with the securities market of America all along, just as it had with the securities markets of other countries, but it had played a relatively minor role in the American market until the very day or two when the time had arrived for playing a larger part. Somebody with a gift for word painting could produce a vivid picture of the activity in the New York offices of the company on recent days when the company's large purchases of American Securities were made. They were not days of feverish excitement and confusion. The studies of the various departments, days and even months before, had made the members of the committee perfectly certain in their own minds as to what securities to buy and the prices that could properly be paid. With the specialists at their elbow and reports immediately available, if unexpected opportunities appeared, the committee did its day's work, with the results that are now known in a general way, to have been very satisfactory. For this group, at least, the transactions it made were no more to be described as stock market gambling than the purchases of grain by a miller or of iron ore by a machinery manufacturer or of paper by a publisher are gambling. They were buying in the light of expert knowledge of real values and of real earning power.

Mr. Rankin at the outset described the organization and operations of the investment and research department of American Founders Corporation.[12] He stated that the department employed approximately 75 persons distributed among several divisions, which included an economic division, an appraisal division, a library division, a division for domestic securities, and another for foreign securities. The foreign division was the largest and was comprised of seven subdivisions, among which were: a Central European division (Germany, Poland, Austria, etc.), a British division (which included South Africa and Australia), a South American, a Japanese, an Italian, and a Scandinavian division. The American division was subdivided according to industries and included industrials, railroads, public utilities, banking and insurance, and oil and mining. The economic division, in charge of Dr. Rufus Tucker, devoted itself to studies of the economic conditions within the various countries, world-wide trends of commodity prices, and "fiscal matters of all kinds."[13] It was the function of the appraisal department to "constantly price the value of securities, usually once a month."[14] In the library division there was a large clipping bureau which clipped many

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[12] Op. cit. supra, note 9, at 24819 et seq.

[13] With respect to the economic division, Mr. Rankin testified in part (id., at 24824):

Q. Would Dr. Tucker send you recommendations or how would he fit into your department?
A. He fitted both ways. Sometimes we would ask his department to study a situation or a particular country or perhaps more frequently from his department would emanate recommendations concerning those things.
Q. And his recommendations or his advice would have to do with trends, I suppose, as to the stability of countries?
A. That is true.
Q. Whether depressed or inflated?
A. That is true.
Q. Whether it was a good time to buy bonds or stocks?
A. That is true.
Q. Or whether agricultural conditions were good, is that right?
A. That is what his department was set up to do; yes, sir.

[14] Mr. Rankin stated (id., at 24821):

"At the end of every month the appraisal department took the holdings of each trust and appraised them from a market angle, or as near a market angle as could be gotten * * *. It also followed what were called the restrictions on investment policy of each of the trusts with whatever was found in the charter and bylaws and that department had to follow those

foreign newspapers; there were "all the foreign stock exchange sheets and a great many periodicals."

The manner in which securities were accorded a place in the portfolio of the various Founders companies was described by Mr. Rankin as follows: [15]

A. A recommendation would usually emanate from one or two places. It would either emanate from the investment division—I mean by that either the domestic or foreign division, either one of the departments. All that came directly through the head of the department to me, or it might emanate from the economic department with the economic department having made a study of some commodity such as tin and recommend we examine all companies producing tin and then it would go from the economic department to the particular place that would examine that. In that case it would be the British Division.

Having come that way it either came to me, either with a long report concerning the company together with what we call the master cards, which gave balance sheets for five years and ratios worked out and a mass of detail that way. It would come through with a long report that way or possibly maybe a pencil report and recommendation. Then I would make my recommendation on that and send it to Mr. Devendorf. From him it would go to other members of the investment committee. Having done that it would then go to Jersey for approval of the president of the subsidiary trust if that investment was to become a part of the portfolio.

That is the strict mechanics of it. As a matter of fact every morning we used to sit together, Mr. Devendorf, myself, and two other of the men in the department and usually the head of the subsidiary trust and discuss the various matters that were coming up. Sometimes suggestions emanated from that group to study certain things. So, the Group knew pretty generally what was flowing through.

Mr. Rankin was of the opinion that the "set-up" of the department, theoretically, was "excellent." [16] However, despite the painstaking work of his department, Mr. Rankin conceded, the final decisions with respect to investments were not made there but were made by an "investment committee," comprised of the three or four individuals who constituted the "inner management group" of the Founders system. Mr. Rankin testified: [17]

Q. One detail that I would like to get at, Mr. Rankin, you referred to two other men in the investment committee?

* * * * * * *

Who were they?

A. The investment committee in 1928 I think consisted of Mr. Coombs, Mr. Erwin, Mr. Seagrave. That may be wrong. Somewhere about that time Mr.

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things and made the report that went to the directors that might have come in a particular trust in the restrictions."

Presumably, therefore, even if the directors of International Securities Corporation of America had not been cognizant that they were violating the restrictions contained in the bylaws and indentures of their corporation (supra, p. 2344), they should have been advised to that effect by the appraisal division.

[15] Op. cit. supra, note 9, at 24822.

[16] He testified (id., at 24825):

Q. The set-up of the department theoretically and ideally apart from what happened to Founders Group was, as you look back upon it, excellent, was it not?

A. Yes; I think it was.

[17] Id., at 24825.

Devendorf went on that committee I think in place of Mr. Erwin, and some place about that time there was that change in that committee. At first Mr. Devendorf didn't sit on that committee and about that time became a member of it.

Q. This is true, is it not, in general that in these organizations the final decisions were decisions as made by Messrs. Coombs, Erwin, Seagrave, and Bull, and later by Messrs. Coombs, Erwin, and Seagrave?

A. That is true.[18]

* * * * * * *

Q. Practically did you find this kept very firm and thick the corporate walls that separated the subsidiaries from the top companies?

A. Not very, but the subsidiaries had committees and frequently would ask for a lot more information than we had given them about securities, and occasionally would say they didn't want that security.

Q. Did they say that occasionally?

A. Occasionally, not very frequently.

Mr. Rankin was questioned concerning his opinion of the honesty and accuracy of the Founders advertising and the reiterated claims of the Founders management that the companies of the group were able not only to withstand depressions, but to profit from them. When it was pointed out to him that all of the investment profits of the Founders companies from 1928 to 1930 were realized by the Founders companies, not from international operations, but from dealings in the securities of one another and of their affiliates, Mr. Rankin professed not to have been cognizant of these facts. He stated, "I confess I am astounded at the size of the figures * * *."[19] Pressed to explain what assistance was afforded by the much publicized investment and research department in the realization of these profits, Mr. Rankin avowed, "I don't think the investment department had to do with these transactions as a department at all."[20] He testified:[21]

Q. You have the record here that 18/19[22] of the profits [of the Founders System] have come from handling of its own securities. Do you call the other 1/19 your ability to handle or sort of an arbitrage between companies? If that is what you mean it seems the explanation wasn't very well put, to state it mildly.

A. As I said before, I am very much surprised at the size of the figures you show for the intercompany transactions and I don't know quite what to make of it as compared to the—

Q. (interposing) The thing I am very interested in is that Mr. Benton said, day before yesterday, that there were several things that made for the popularity of the Founders Group securities and the prices they achieved in the market. He mentioned three things, one was the earning capacity and we have shown

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[18] Mr. Erwin qualified this answer by adding later (id., at 24826): "It applies to American Founders as the recommending agent to subsidiaries. It doesn't apply to what the subsidiaries finally purchased. That, of course, comes to the committee of the subsidiary."

[19] Id., at 24847.

[20] Id., at 24860. For detailed testimony of Erwin Rankin with respect to the investment and research department, its contribution to the profits of the Founders system, and related matters, see Appendix V, infra.

[21] Op. cit. supra, note 9, at 24857.

[22] This fraction had reference to the year 1929 alone. In that year profits of $36,000,000 were realized by sales of Founders and allied company securities, as compared to a total of $38,500,000 realized from transactions in all portfolio securities. (Id., Commission's Exhibit No. X3732.) For the entire period 1928–1930 the profits from intragroup sources represented the only realized profits. As has been stated, non-intercompany security transactions resulted in a net loss over the 1928–1930 period of $3,393,586.

to some extent what earning capacity meant and especially in these latter years it was based upon the intercompany profit or profits in dealing in securities in the group. The second thing he mentioned was the advertising of the skillful investment service and the third thing was the ability of Founders generally in handling the market.

Taking, first, the investment service, the investment service, as I understand, had nothing to do with these 18/19, that was related to the transaction of the company in its own securities.

* * * * * * *

Q. Now repeating that question, the investment service had nothing to do with the profits of $36,000,000 out of $38,000,000 from the sale of all investments, the $36,000,000 represented the distribution of securities in the group?

A. Now, if I understand what the so-called investment company profits are, I would think that is fair. The investment [department] has little to do with this.

Q. I will explain exactly what they were. It is shown on this exhibit they were profits realized by American Founders, Founders General, International, Second International, United States and British, American and General, United Founders and Investment Trust Associates in transactions in Founders companies securities, the securities mentioned over here to the left, and in the securities of the affiliated companies like U. S. Electric, Standard Gas and Electric, Public Utility Holding, U. S. and Overseas.

Now, what is your answer, Mr. Rankin?

A. I think my answer would be the same. I don't think the investment department had to do with those transactions as a department at all.

b. Testimony of E. Carleton Granbery

Several of the directors and officers of the Founders companies were interrogated with respect to the form of financial reports published by their companies and the failure to segregate or otherwise to disclose to investors the magnitude of the sums diverted from capital accounts to income accounts in the intragroup transactions which have been described.

On this subject E. Carleton Granbery, a partner fo Harris, Forbes & Co. and a representative of that firm on the boards of directors of almost all of the Founders companies, testified:[23]

Q. Mr. Granbery, did you read the reports of these companies as they came out?

A. Yes, sir.

Q. You realized that up to 1929 there was no distinction in those reports, no segregation of profits from the sale of securities from other kinds of income, and that in 1929 they did begin to segregate the profit on the sale of investments from interest and dividends, but never showed separately the profit on the sale of securities issued by these companies enumerated here in Exhibit 3732?

* * * * * * *

A. Yes, sir. That is my recollection.

Q. That is a fact, Mr. Granbery. Notice, for instance, in 1929, you had interest and dividends. We are now reading from the report of American Founders Corporation for the year ending November 30th, 1929. You have interest and dividends, and segregated from that is profit on the sale of investments?

A. Yes.

[23] Id., at 25304 et seq.

Q. There is nothing there to indicate those profits from underwriting, those profits from options.

A. Right. Profits as against interest and dividends. Net profits, I assume.

Q. Now, looking at Exhibit 3732 again, taking this figure for the American Founders Corporation, for example, you will observe they show a profit on the sale of investments of $4,393,000. Referring to the Exhibit 3732, you will find a break-down of this item $4,393,000. That shows that $4,400,000 came from dealings of American Founders in U. S. Electric Power, Standard Gas & Electric, Public Utility Holding Corporation, International, Second International, United States and British, American and General, American and Continental. In other words, Mr. Granbery, you will see that all of the profits that came from the sale of the securities came from the sale of the securities of those companies in that year 1929. Did you know that was the fact?

A. No; I am surprised at it, because my best recollection is that in the summer of 1929 the various companies in the group sold a great many securities, cashing in on them, and that they went into the panic in the fall of 1929 with some sixty or eighty million dollars cash on hand. Therefore, it surprises me to see that the rest of the group did not make any money.

Q. This is for November 1929. Again I want to call your attention—we went into detail as to American Founders—to make that clear to you, but if you will observe, for the year ending November 1929, the same thing was the experience of substantially all the other companies.

A. I assume you are correct.

Q. Is that a surprise to you?

A. Yes, sir.

Q. I was wondering, Mr. Granbery, how you ever could have determined from this balance sheet, this income account, shown in the American Founders Corporation report for the year ending November 30, 1929, just how the Founders Group had made its money or lost its money.

A. You couldn't tell from this.

c. Testimony of Don C. Wheaton

Don C. Wheaton, another of the Harris, Forbes & Co. representatives on the boards of various of the Founders companies, testified as follows respecting the authentication of the financial reports by the directors prior to publication: [24]

Q. Did you ever see a report issued to stockholders that had your name on it, Mr. Wheaton, before the report went out?

A. You mean the annual report?

Q. The annual report of these various companies.

A. Yes; as I recall the procedure was that the report, in approved form, was to be submitted to the Board, and it was approved, changed or corrected, and then finally approved by the Board subject to any changes by counsel or by the auditors. Now, I can recall some situations where we did not happen to have a meeting at that time, and perhaps the reports, in approved form, were sent to the individual directors, but I believe without exception that the proofs of the reports were submitted to the Board either individually or as a Board at a Board meeting.

Q. Before they were sent out?

A. That is my recollection, sir.

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[24] Id., at 23124 et seq.

Q. Up to 1929, in any event, through the reports that were issued for that year, do you recall that none of these companies with whom you were connected, segregated earnings or the profits from the sale of investments from their other earnings, do you recall that?

A. You say do I recall now, or do I recall then?

Q. Do you recall now?

A. Yes.

Q. Did you know then?

A. I recall that they did not, sir; they did not segregate.

Q. Did you know that at that time, Mr. Wheaton?

A. Yes.

Q. Did not you, as a distributor of securities, think that was bad practice at the time?

A. No; I would not say that, sir. I will say as my education has progressed over these ten years, along with the development of the investment trust movement, and with the attitude of the public perhaps changing, and with S. E. C. requirements, I should probably say today that there might be a break-down. As I recall it, the various companies did—I do not know how soon, but the reports were broken down, both the income and expenses, as I recall. We started in a period when they were all lumped and we ended up by the breakdowns. Perhaps I do not make myself clear.

Q. You make yourself quite clear, as I understand it, at least. You think there has been a progression in thought in that matter?

A. I do, sir.

Q. But at that time you think it was not uncommon practice to find them given as one item?

A. I would say that it was probably uniform practice not to do that, not to break them down. And, furthermore, I think we had the support of our auditors in that policy.

Q. I was just wondering, Mr. Wheaton, how you would feel if one of your own analysts reported a particular security to you and in his report failed to make that break-down. Would you think that was a sufficiently informative report?

A. Well, it would depend, of course, upon the purpose of the analyst's report.

Q. Well, suppose Harris Forbes wanted to buy securities and all that you got was a report from an analyst lumping the income, whereas, in fact, a very substantial proportion of that income came from profits from securities within the group. How would you feel about that, if that were not reported?

A. Well, it would not be so much the lumping, as I understand your question, today as it was perhaps there were what we call nonrecurring items that might be pointed out. The report made for Harris Forbes, for their buying department I imagine would be in the most minutest details I would certainly assume that would apply to earnings, expenses, and so forth. Whether or not that type of complete report is comparable to a report to stockholders, I am not prepared to say.

Q. You certainly would not approve of a report today that went out to stockholders and contained, lumped with things like dividends and interest, nonrecurring profits, would you?

A. I think perhaps that is true, we probably would not, because the report, when it came to us from the auditors, would probably be broken down.

Q. That is what I would like your judgment on, because, after all, you were a bond salesman; you were a person that knew what was proper to recommend to customers and what was not proper to recommend to them. The fact is that the auditors, in their report to the management, did break down these items, and

break them down minutely,[25] but that the managers, in their report to the public, and you directors, in your report to the public, did not break them down?

Mr. RIGGS (of counsel to the Founders Companies): Mr. Stern, I do not think that is quite correct. The auditors did make detailed reports to the management, but the proofs of the reports which were submitted to the directors, for approval by the directors, were in the form in which they finally went out to the stockholders. The report consisted of two parts, the text and certification of the balance sheet and income statement by the auditors. I do not think there has been any proof it was submitted to the directors in a form where it was to be segregated and broken down, and the directors lumped it together. We had Price Waterhouse; we had Loomis, Suffern & Fernald, and also Clarke, Oakes & Greenwood, who had reported and certified the balance sheets in that way. Beginning with 1929, it was segregated into interest, dividends and profits, and thereafter kept that way.

By Mr. STERN:

Q. You heard what Mr. Riggs had to say?

A. Well, I would have answered along these lines: That a detailed report showing a break-down in more detail than was the published report I do not recall seeing, as a part of the approval of the reports. What we saw was the report and the figures combined in the way it went out to the shareholders.

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Q. Do you think that is a properly informative statement to go out to stockholders without breaking down further the income derived from the profit from the sale of investments in general portfolio and of profit derived from the sale of securities of the affiliated companies?

A. Well, I would answer that like I did before, Mr. Stern. I believed it was all right at that time. In the light of subsequent events we probably would break it down, and you would probably have a great deal more detailed disclosure.

Q. We are never, I suppose, wholly logical, Mr. Wheaton, but I wonder what would have been your attitude at that time toward an analyst for your company who had failed to make the break-down in reporting to you the earnings of the company in which you were going to make an investment?

A. I do not know what it would have been, sir.

Q. It would have been highly censorious, would it not, to say the least?

A. Well, the point was that we were given these figures, and we assumed that the form in which the auditors and counsel approved it to go out was all right, and we agreed to it then. In the light of subsequent developments I would say today earnings statement should be broken down, of course. Now, you ask me what my reaction would be to a report of an analyst who did not do that at that time. I cannot say, Mr. Stern.

d. Testimony of Leland Rex Robinson

Leland Rex Robinson joined the Founders organization in 1925 and subsequently became president of Second International Securities Corporation, director of International Securities Corporation of America, and a trustee of Investment Trust Associates. Dr. Robinson was the author of the book "Investment Trust Organization and Management," which was published in 1926 and revised in 1929.

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[25] It was pointed out, supra, p. 2220, that the auditors submitted detailed reports to the management, but that in the reports to stockholders the accounts were "lumped" so that it was not possible to tell from what sources the income of the companies was being derived.

When examined as to whether his reputation as an authority and expert in the investment trust field were not publicly exploited by the Founders management, Dr. Robinson testified: [26]

Q. What did you assume was your function when you first went to the Founders group of companies?

A. I was, as I said, perhaps the best known of the American students of British investment trusts. I had made numerous trips over there, and I assumed my function was to advise, whenever my advice might be called for, as to my knowledge of British companies, in the light which their experience proved we should or should not do in the States.

I was vice-president of the International Securities Trust at an early date, and in that capacity my duties were rather varied. I sat in the directors' meetings and participated, as I could, in formulation of general policy.

I spent some time on, I should say, one-quarter of my time, in the preparation of advertising copy which when approved by Mr. Seagrave, very frequently saw the light of day in financial publications.

I spent considerable time in my earliest connections there, in writing my book that appeared in 1926, because we felt the whole idea of investment trust at that time was an unknown quantity in this country. Anything that could be done to enlighten us with respect to what the institutions were, would be indirectly a contribution to the business.

I made a great many speeches, and wrote a great number of technical articles for a wide variety of technical magazines. I have a whole shelf full at home.

Q. In 1929 you wrote this book which is a revised edition?

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Do you know how long that book took to prepare, and when it was actually published?

A. As I recall, I was in Europe the summer of 1929 and the book was in page proof at the time I sailed and came out in October of 1929, I think. It may have been late in September. My associates were extremely generous with me. For the better part of the year before that time they permitted me to devote my time to that book, and I think it was pretty much of a solid year's work. It was in no sense a rehashing of my earlier work.

As I recall, though I can't be sure of the dates, from eight to ten months of quite concentrated work was put into the preparation of the text of that book prior to July or August of 1929 when I went abroad.

Q. The book itself had a great deal of reference to the experience of [the] companies as a group [Founders Group], did it not?

A. Yes; I think not disproportionately to their importance. It was a book which sparkled with innumerable references to all kinds and conditions of companies, foreign and domestic.

There is, as I recall, one chapter of which a considerable part is devoted to an actual description of the technique of investment flow of American Founders Corporation, regarded as the investment fiscal agent of the International Securities.

Q. But references were throughout the book to International and other companies of the group, and they were—

A. And other companies also.

Q. And other companies were mentioned as well, of course.

A. Yes.

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[26] Op. cit. supra, note 9, at 24947 et seq.

Q. Now, that book was referred to from time to time in the literature of the company, was it not?

A. I suppose so. I think it has been; yes.

Q. And your name was used in connection with the companies, as well as the trustees, in the circulars that went out. I mean your office was correctly described.

A. Certainly.

Q. To the extent—I don't mean to imply that this was unfairly done, but to the extent that the publicity value it had, your connection with the corporation was thoroughly exploited.

A. I think there may be an implication in your statement that I don't quite like. I wish to make the statement that at no time was I not wholly free to put anything in that book I chose. At no time was the slightest pressure brought to bear on me to say or put anything in that book.

Q. I don't think you will find that inference possible from anything in my question, Mr. Robinson.

A. I beg your pardon, Mr. Stern; I take that back.

Q. I did not mean to imply that your freedom of utterance was curtailed, or that you would have permitted it to have been curtailed. But what I mean to say is, the fact that you were connected with the company and had written this presumably representative book, was not unnoted in the advertising of the Founders group.

The EXAMINER: You took no steps to discourage it?

The WITNESS: My colleagues had given me a year in which to write the book, in which time I carried on a certain amount of routine at my office and attended a great many meetings, but had not taken active part in them, and I felt they were entitled to make use of whatever reputation they could for good or ill.

The EXAMINER: You were being compensated by this group at this time?

The WITNESS: Oh, yes; I was on salary.

By Mr. STERN:

Q. Also, is it not true, Dr. Robinson, that the fact you were connected with this company may have had some advantage for the company by way of prestige, having someone on the board who was a known authority, and advertised as being a known authority in this field?

A. I think, particularly, Mr. Stern, in the earlier years that was true, because I have been told that my earlier connection with the Department of Commerce and my studies in London as financial trade commissioner, were among the things that drew me to the attention of my later associates.

Q. The fact that you were held out to the public as being a member of this group, and had written a representative treatise, would be some indication to the public that the sound principles laid down in that book would be somewhat followed with you on the board?

A. To the extent the statements were made in the literature, yes; and there are various references in the literature to the ways in which the companies functioned.

I would not go so far as to say that at any time I thought there was any implication, because at that time I had a minor role in one of the companies, that that was proof that all of my ideas freely recorded in this book were freely carried out. I think no such implication was intended or given.

Q. Your book not only referred to the English prototypes and pointed out their good points, but pointed out their bad points?

A. I am afraid I found the good points more extensive than the bad.

Q. But you also pointed out the evils existing in the British system?

A. Yes.

When examined on the soundness of the Founders holding-company system, and the conformity of the investment policies of the system to the representations made to the public by these companies and to the theories expounded in his book, Dr. Robinson testified: [27]

Q. For good or evil there was no prototype of the American Founders group?

A. Not as far as I know.

Q. No English prototype of your company that got its money from the public, managing the destinies of subsidiary companies that also got their monies from the public?

A. I certainly recorded none in my studies.

Q. And as you now view it, that set-up you would not at all approve of?

A. That is rather a tall statement. I am afraid I will have to have a moment to explain.

Q. Have you any hesitation—Or, I will ask you directly. Do you approve of a company getting its money from the public, raising its funds from the public, having its own stockholders, holding and managing the affairs of subsidiaries that likewise get their money from the public?

A. I don't like the holding company principle at all in the investment trust field, particularly, Mr. Stern; I am dead against it.

Q. And did not, Doctor—

A. I have tried to explain at various times, but the principal reason is I think the investment trust companies can be best managed with one vote per share, a comparatively simple capital structure, and when there is no undue pyramiding of assets.

However, I do not disapprove of the financing of a company for the purpose of serving as a fiscal agent of an investment trust, if the service it renders is disinterested service at a fair price.

I do not like to see such a company in control of the other investment trusts it serves as a client.

Q. Will you read that answer?

(The last answer was thereupon read by the reporter.)

A. That sounds rather complicated. I personally do not like the holding company principle in the investment trust service. I can see no theoretical objection, however, to the creation of the management agency or sort of investment counsel, which specialized in the management of any number of investment firms if the relations are purely that of principal and client.

Q. And entirely at arm's length?

A. Certainly; yes.

Q. Now, you stated in your book, in the 1929 book, some of the evils that were faced by these—or experienced in connection with the British trusts in the first half of the decade, 1890 to 1900, and one of the evils was the practice of certain of these early investment trust companies buying too freely on rapidly rising securities markets without duly weighing investment values, and without giving adequate consideration to investment markets, and securities groups. That was one of the evils and that evil was reproduced in the Founders group.

A. I think it was very general, and the Founders group was no exception, certainly.

Q. It is not the fact that the Founders group was no exception, Doctor. It is the question whether or not it is possible with an organization apparently care-

[27] Id., at 24952.

fully selected, to avoid evils that are known, and that have existed in the past. That particular evil disregarding investments or not regarding investments as highly as speculations is something that I should say an investment trust should safeguard a client against. Would you not say so?

A. I would say in many respects we did that at 50 Pine Street.

For instance, the way International Securities, and Second International Securities held out of the American stock market during 1926, 1927, and 1928 largely, the rather substantial volume of cash carried over through the first crash, the latter part of 1929, where we made one of our great mistakes, I think, was in doing what so many other institutional investors did, and I think we underestimated very much the extent and nature of the bear market.

Like Colonel Ayres, and a lot of other people felt in 1930, that the worst was probably over, they made that mistake. We prided ourselves on the volume of securities we picked up in the fall of 1929. Look at the composition of investments of any of the real investment trust companies of the group. Take, for example, the Second International Securities Corporation and see how large a part of the entire assets were in bonds, preferred stock, and cash, mostly foreign bonds, through to the virtual end of 1929.

And we began, of course, more largely to go into common stocks, and we came in too soon. That was one of a number of mistakes we made. But I think we kept that precept in mind as far as we could.

When asked what objections he had voiced to the investment policies of the Founders companies, and to their practices respecting inter-company profits, Dr. Robinson testified: [28]

Q. Did you raise your voice and say "We are getting into speculation now and our function is investment," along in 1929?

A. In connection with International Securities or Second International Securities?

Q. In connection with the group generally.

A. In 1929 when I spoke, I spoke for the Second International Securities primarily. I was president of the company at that time and my time and energy was devoted to the watching of Second International. I did not raise my voice in 1929 in respect to Second International Securities Corporation.

Q. You will recall that the advertising was not always so discriminating, that the advertising referred to the Founders Group, and there was a definition of Founders Group as including American Founders and the rest of the companies?

A. Yes.

Q. That was part of the advertising of the group?

A. That is true.

Q. You knew then that your name was associated with the so-called Founders Group?

A. I knew my name was associated with certain investment companies, and we had most scrupulously from the very beginning, kept my name from being associated as a director or officer of any other than an investment trust company except Investment Trust Associates.

Q. Did you know that Investment Trust Associates was one of the companies most largely concerned with the question of inter-company profits? Did you know that?

A. I understood that was so.

Q. Was your voice raised in any objection?

[28] Id., at 24955 et seq.

A. No; as a matter of fact I am afraid I was not really functioning as a trustee ought to at that time, but even if I had been so functioning, I don't know that I was that wise at that time, that I would have raised my voice. But, in connection with my primary duty, and that was Second International, I did not raise my voice. I thought there was no occasion to do so in 1929.

Q. As a matter of fact, of course, the investment trusts per se, those that kept as religiously as they could to the good British precedents laid down in this book, they came out on top, did they not?

A. You mean the British?

Q. Those of the companies like Internationl and Second International, and U. S. and B. I., and American General, to the extent that they stuck to their knitting and engaged in investments, and didn't engage in speculation, they came out best, better than American Founders and United Founders that went in for things other than that?

A. Yes.

Q. But you have known all that, Doctor, and also had known you were held out to the public as a unit. That made no difference to you?

A. Mr. Stern, I can't admit that because the one thing I pleaded and have been pleading very continuously ever since I started to write on the subject, is not to confuse investment trusts with holding companies, and I made a particular point time and time again to call attention that American Founders and United Founders were not investment trusts in any sense of the word.

Q. Sometimes they were referred to as investment trusts, and sometimes as holding companies, but in the advertising—

A. Not by me.

Q. And it is known as the Founders Group in advertising?

A. Yes, but I didn't claim any responsibility for that whatsoever. The advertising I worked on had to do with International Securities Trusts of America.

When examined upon the practice of the Founders Group of paying cash dividends without allowance for market depreciation and capital impairment, Dr. Robinson testified: [29]

Q. Another evil referred to was this: "The struggle to enhance earnings and increase dividends, even by devious processes, during times of rapidly accumulating capital, and of multiplying security prices. Endeavor to realize trading profits lead companies into transactions which would be universally condemned today as too unsound in character to warrant serious consideration on the part of responsible investment trusts. In order to realize profits from financing, dealing, issuing, and underwriting, several companies spawned flocks of new ones engaged in a variety of promoting, financial and investment activities, and creating a pyramid of paper values. A few notorious instances can be cited of the disbursement of cash dividends without allowance for heavy market depreciation and without reference in the reports to the existence of real capital impairment." Were you aware those things happened in connection with the Founders Trust?

A. I was aware of the fact and in a great many ways, more ways than one, those companies of this group, apart from the investment trust companies which I served, were run on principles very different from those of the British investment trusts, and I think such things you have read there strike home.

Q. This has been so adequately and eloquently expressed in your book, why didn't you see the handwriting on the wall and say something about it? You realized the degree of pyramiding, didn't you?

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[29] Id., at 24958 et seq.

A. I like to think I did. We were all a little crazy in 1929, and I think I showed that.

Q. But the question of the man being crazy who is inexperienced in these things is one thing, and the question of an expert being held to a higher stage of sanity than other people is another thing.

A. Yes.

Dr. Robinson felt that it was not incumbent upon him to protest against the pyramiding of the Founders companies although in his book he criticized that type of structure: [30]

Q. And I was wondering if your voice was ever raised against the pyramiding done, the pyramiding going on in these companies.

A. You mean United Founders?

Q. That is a perfectly excellent illustration, yes.

A. My voice was not raised against United Founders for I had nothing to do with United Founders. I was told about it when it was ready to start up.

Q. Had you participated in United Founders?

A. I had participated in United Founders.

Q. And became a stockholder?

A. Yes.

Q. And made a profit?

A. And made a profit.

Q. Don't you think the fact it was profitable might have had something to do with your silence?

A. I don't think so. I didn't think it was my concern. I thought at the time, and I am sure I expressed myself so verbally, that that would mean the beginning of the end of the real independence of the Second International Securities which I had put my whole heart and soul in, and perhaps the International Securities Corporation. I really didn't know enough about it and was not sufficiently concerned to have raised my voice.

As I look back now, I had some misgivings, but I don't recall raising my voice or feeling it was up to me to do so in any way, shape, or manner.

With respect to intercompany dealings and the "profits" resulting therefrom, Dr. Robinson testified that he had supposed the Founders companies were "singularly free" of that type of transaction and "was surprised" at the proportion of intercompany profits: [31]

Q. Did you know that a security, that the same group of securities that would be sold from one company to another company, and another company, and back to the same company?

A. No. I have always supposed that we were singularly free of what you would call intercompany transactions, in the sense in which I have understood intercompany, the sale by company A to B and company B to company C and company C to company A.

I know what you are coming to now, and like Mr. Rankin, I was surprised at the time of the private hearing to see how very large the underwriting profits with the investment profits were in 1929.

Q. Apart from the underwriting profits and investment profits, $13,000,000 is a large amount to be shown by intercompany profits?

A. I don't accept that figure.

Q. I will show it to you.

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[30] Id., at 24959–60.

[31] Id., at 24960 et seq.

A. Is this thirteen million for Second International or United and American and all the group? I have the exact figures here from the reports of my companies if you wish them.

Q. I am talking about the companies of the group. The thing that is concerning us at this point, Doctor, to be very frank, is the use of your name, the use of your book, the use presumably of the sanction of having a man of your experience and background and probity in connection with matters of this kind, the things you have stood for and the complete departure from those principles over and over again as these exhibits show.

A. I will not admit the complete departure from those principles by the companies for which I had any power whatsoever. The group grew in such a way as to astonish and bewilder me. You probably know more about it than I do now. I know in 1929 at the completion of this book, I was deeply engaged and things happened that got beyond me, but I kept my eye on my own companies.

* * * * * * *

Q. I want to say that there is no suggestion here that we think that the company paid anything for the publication of the book which Dr. Robinson did on company time.

A. My salary was very small, and I think I fully earned it, despite the fact that many days I was in for an hour or two and many a day I was not in the office at all.

Q. I want to say this in fairness to Dr. Robinson, and also in fairness to our point of view. The significance, it seems to me, of this is that Dr. Robinson's connection with the company was widely advertised and this work did make reference a great deal to the affairs of the companies of the group. It also made reference to the affairs of the companies not in the group.

I don't mean to imply that it didn't—The difficulty I see in this is that Dr. Robinson's connection was advertised, and that the principles that were laid down in the book were not followed.

With respect to the sums diverted to income accounted by the Founders group through the intercompany transactions in the securities of these companies and the failure of the Founders management to segregate and identify these "profits" in the published reports of the companies, Dr. Robinson testified:[32]

* * * they should be separately stated from other income, and I would go further and say any such thing should be completely disallowed. I don't believe in underwriting profits having any connection with associated or affiliated companies. They are entirely out as far as I am concerned. I say that despite the fact we made a huge profit in 1929 as a result of it, and carried a large part of it forward in actual profits. In other words, it was a profitable thing.

Dr. Robinson further testified on this subject as follows:[33]

Q. Then, I call your attention to:[34] "Perhaps the obvious conclusion to which a student comes in reviewing this brief period of British investment trust history is the failure in earlier years to distinguish adequately between the functions of financing origination and distribution on the one hand, and those of investment on the other."

A. That is very true.

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[32] Id., at 25000.

[33] Id., at 24977 et seq.

[34] An abstract from an article published by United States & British International Company. Ltd., July 1, 1929. (Id., at 24974.)

Q. That is very true; and that was very unfortunate so far as this group was concerned.

A. In that particular I think you have made a very good stroke against me in that we come down to where I am interested, Second International Securities Corporation. It is true that in 1929 large underwriting profits were taken by Second International. Underwriting profits are entirely legitimate for an investment trust with safeguards I have mentioned, but I feel we made a great mistake and I feel this is what you are driving at, what you were driving at all this morning, and I want to meet the issue squarely, in not segregating in 1929 the underwriting profits from any investment profits, that is, profits that come from the true order of investments in our general portfolio.

* * * * * * *

Q. As a matter of investment policy, you, of course, know, and you have stated in this book [35] perfectly, the distinction between the financing of new and untried enterprises, the originating of securities, and the serving as fiscal or management agency for industrial or public utility undertakings, do not belong among the true investment trust functions, and yet the risks inherent in this kind of business were ambitiously and rather blindly undertaken by several early investment trust companies.

That fault in the early British companies was also a fault and an error repeated in the Founders Group?

A. With this difference in the practical outcome, the chief criticism I have of my own company, the Second International, was that we made too much on that sort of thing without clearly separating it out and showing to what extent our earnings were dependent on that. The early British companies made some tremendous losses in that sort of thing; we made profits.

Q. Except in things like—

A. I am referring to that. My knowledge does not extend much beyond the companies I served as officer and director, I mean Second International Securities, of which I was president. We made a substantial amount in 1929 in underwritings which at the time seemed perfectly legitimate and proper. I should strongly favor today, however, separating that out.

* * * * * * *

In the 1929 reports of these companies, at least of those with which I am more familiar and for which I have felt a sense of responsibility, we pointed out that while our interest and dividend income, as I recall, was about what we might expect on a recurrent basis through the years, our profits for the year 1929 were about what we might ordinarily expect.

When we brought out the 1929 reports a good many of us felt that we ought to take cognizance of the fact in the text of the report we assumed the people would read—the texts were rather brief—that 1929 had been a most unusual year and we so stated, and I now wish, and I can't tell you how much, that we had gone a great deal further than that.

Q. One of the difficulties I find in this situation is that at this period of time the company stressed and continued to stress the fact of its ability to go from one country to another, and nowhere was there stressed that company profits were made by the dealings in securities of the companies of the group.

A. It should have been done undoubtedly, and I think the statements made were entirely correct so far as they went.

[35] Robinson, Leland Rex, *Investment Trust Organization and Management* (Revised Edition, 1929).

Dr. Robinson indicated that he strongly disapproved of the lack of segregation in the income statements of the Founders companies, but had not "pushed" for it: [36]

Q. And, Doctor, in your book you warned over and over again of the dangers of the lure of speculation and letting the incentive of profits made from turn-over rule anyone in this situation. You also in your book made perfectly clear—and this, Doctor, is particularly relative in the case of your company—in your book you have made it perfectly clear that in England the investment profits were not treated the same as income. You knew that and you knew it was a conservative practice; rather more conservative than the American practice; but you pointed out that profits must be treated separately from other income.

A. That they should be.

Q. That they should be. You also gave a form of income statement in your book which shows profits treated separately from other income.

A. Yes, sir.

Q. And that was based upon financial grounds so well known we need not pass on them?

A. Yes, sir.

Q. But when it came to giving a report of Second International, you didn't do that?

A. Not prior to 1929.

Q. Why was that? Your accountants did make the separation for you? Why didn't you in your report separate it?

A. We should have done so. There was considerable disagreement among us as to whether we should do it or not. I wanted to see it done. Others didn't.

Q. Who were those that didn't want to see it done?

A. I would rather not mention names, please.

Q. Were they your fellow directors?

A. A number were. They thought there was no necessity for it, nor did I push for it as strong as I should. I take a considerable amount of blame myself as I look back. I don't understand how it could be. I think I should have insisted upon it, but between the ideal and the actuality there is always a very large gap, and it was certainly something I was moving toward and anxious to have done.

As far as the treatment of income is concerned, I think the American Tax System has been responsible for the way the United States Government has treated profits.

Q. Assuming that has been a factor, there is nothing in the tax law that profits shall be set in the same heading with your income?

A. Certainly not. The big issue there, much bigger than anything else, is that, properly speaking, profits have no part in income. We will never have sound investment accounting until they are excluded from income altogether.

May I finish that comment by pointing out there was a time when the Scottish Revenue Authorities treated the issue in Scotland as our Government does now, but when the Revenue Authorities of Scotland and England, which has been true now for many years, applied uniformly this distinction between finance companies and investment companies never to pay dividends out of profits, then the accounting system became uniform, and I hope we will move toward this in this country. We are bound for ruin if we do not.

Q. This is a fact. When American Founders has stock on its books at 20 and sells to Investment Trust Associates at 25 and takes it back at 25 and registers a profit of 5, that isn't any real profit?

A. Of course not. Profits only come when you are dealing with a free market.

[36] Op. cit. supra, note 9, at 24997 et seq.

Q. You made that perfectly clear in your book?

A. I want to make it clear now. It is a personal conviction of course.

Q. You stated your conviction was unequivocal and uncompromising in prior hearings, but you never really actually voted in favor of that on the books of Second International?

A. In favor of what?

Q. Segregation.

A. The thing never came to a formal vote. I think if I had pushed as much for it as now in retrospect I wish I should have, it would. We discussed it in the meetings and we would, one or two of us take a strong position against it, and some in favor of it, and we finally came to that degree of segregation even antiquated in 1929, and from that time forward did segregate.

Q. And the statements or files showing a commingling of the two does allow a plain avenue open to misrepresentation by salesmen?

A. Obviously any earning statement which includes any profits, whether segregated or not is misleading because profits in the very nature of the case are not recurrent. The question is whether they are ever included in income. They have no right to be there. I stood for their being included in income for a number of years and the reason why I honestly believed at that time that we had an organization at 50 Pine Street that would make the Scottish organization sit up and take notice and I remember how thrilled I was when one of the oldest and best known investment men in Scotland came over and how amazed he was. We all thought we were going to make our 8, 10, and 12 percent a year. We felt even if it cost us twice as much as it cost the British it was all right, but we were wrong.

* * * * * * *

Q. * * * You will observe in Exhibit No. 3404 you do segregate, which is the statement for November 30, 1929. In that you do segregate interest and dividends from profits on sales and investments.

A. Yes. That is an unfortunate term. It is misleading, but it wasn't intended to be.

Q. But you do not indicate how much of this is profit on sales of investments, and it is apparent all of it was due to dealing with securities in the group?

A. Yes, but I am not going to admit it was securities in the group.

Q. It isn't a matter of admitting it, but a matter of true reports?

A. I suspect what is true is what Mr. Rankin pointed out, we had very large gross profits from the sale of our miscellaneous portfolio. I don't think it is altogether fair or scientific to make that statement.

Q. We were talking about the year 1929, and in that year there was no net profit made from sale of investments, only net losses.

A. That is right. I believe that is correct. In other words you are bringing up the question whether this is a proper designation. I say it is not, sir.

Q. No; not only that, but I am bringing up the fact that this is an unfair statement to make without showing substantially all these profits if all of them did no come from the sale of securities in the group.

A. I agree with you, but I will say there was no bad faith involved at the time. I think I ought to be permitted to put in the record several things in this connection.

In the first place Second International had reserved to itself the right to underwrite. Underwriting was, has and is a legitimate function of investment companies where properly limited. These profits were actually made in the issuance of securities of affiliated companies in pursuing the investment trust business for the most part, and having their own assets which did not represent intercompany transactions with ours. We made large profits that year and when the accountants called them profits on sale of investments I am

confident the accountants were entirely honest about it, but looking back I fully agree with you. It is a term that leaves a great deal to be desired and personally I don't like any of it.

May I call your attention to this fact, if you take the profit on the sale of investments in companies I am interested in, Second International, United States, and General, you will find out a very large part of those profits were actually carried forward. In other words they were profits actually made and to that extent—

* * * * * * *

Q. Let us see. There is Second International 1929, the fiscal year ended 1929, the total profits from distribution and disposition of securities of Founders Company and other companies in the group was $2,495,000, and the total profits from disposition of all securities was $2,232,000. This shows there wasn't any profit made that year except by selling securities of the companies in the group.

A. Yes; but the point I am making from the standpoint of the Second International that was real money. It was real underwriting profit. It wasn't just air or paper, it got into that company in the form of good cash profits which we later invested.

Q. I don't know whether you happened to be the beneficiary of certain gifts made to you by American Founders or United Founders at that particular time so that profits might be registered instead of them going into a capital of the company, I don't know.

A. There was no choice there.

Q. I don't suppose you, any more than Mr. Seagrave, would approve of a practice that would bring to your company $7,000,000 in profits through dealings with the securities?

A. Mr. Stern, I disapprove of the whole damn business, but I still make my point, from the standpoint of Second International it was a real profit.

e. Responsibility for Failure To Identify and Segregate

The responsibility for the failure of the Founders companies to identify and segregate the so-called "profits" derived from inter-company transactions and the sale of one another's securities was readily placed by the officers of the Founders companies upon the independent public accountants who were charged with the preparation of reports. Louis H. Seagrave, president of American Founders Corporation and of United Founders Corporation, testified:[37]

Q. And with so large a proportion of profits indicated in the securities of the Group, it never occurred to you at that time that it was important that that should be separately stated in the reports to the stockholders?

A. I would say again that it did not. I was not an auditor; I relied upon the auditors we engaged for the purpose, and the way they set it up I thought was correct.

Q. So that it was for the auditors to say whether or not that was good or bad from your point of view?

A. It certainly was.

Q. If they passed it, that was all right with you?

A. It certainly was.

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[37] Id., at 24118.

Frank B. Erwin, president of Founders General Corporation and a director of most of the Founders companies, testified:[38]

Q. For your information, Mr. Seagrave stated that so far as the presentation of these reports was concerned they depended absolutely on the accountants, and if the accountants would have told them to break down the items they would have been glad to do it; and that would be your statement too, that when these came with the signature of a certified public accountant affixed to them and even though your individual ideas may have been different, you said, "Well, if that is the standard form I understand it, and I can tell people if they ask me, but if this is the way they want it to go out it is all right with me."

A. Yes; that would be my answer to it.

The accountants, for their part, conceded that "today" there would be segregation of such items. W. Homer Conkling, member of the accounting firm of Loomis, Suffern & Fernald, testified:[39]

Q. From 1929 on there was a differentiation but there was still a failure to differentiate profits on securities generally and profits on securities in the Group. I take it today you would insist on the differentiation.

A. Today we would insist on differentiation of profits in the Group.

Franklin Bowman, member of the accounting firm of Haskins & Sells, testified:[40]

Q. * * * from time to time in recording the profit made by the various companies in the Group, there was a failure to segregate profits from the sale of securities and from other income. That, I take it, you agree with the other accountants should not be done as you look on the practice today.

A. I think profits should be segregated from other income.

Q. And similarly, the profits accruing from the sale of securities of companies within the Group should be segregated from other profits.

A. I think that is desirable.[41]

As has been previously pointed out, if these sums had been properly segregated and explained, there would then have been posed for consideration of the stockholders and the investing public the question whether many of these sums could rightly be considered profits or income at all.

C. Other Distortions and Concealments Resulting From Accounting Malpractices of the Founders Companies

1. OVERSTATEMENT OF SURPLUS ACCOUNTS OF AMERICAN FOUNDERS CORPORATION AND UNITED FOUNDERS CORPORATION

a. Write-Up of Securities and Issuance of Stock Dividends Against Surplus Thus Created

Commencing with the year 1925 and continuing until the end of 1929, American Founders Trust (subsequently American Founders

[38] Id., Commission's Exhibit No. X3737 (p. 172).

[39] Id., at 26729.

[40] Id., at 26827–8.

[41] The respective Founders companies served by each of the accounting firms in the capacity of auditors or "consulting accountants," have been set forth in tabular form in note 72, supra, p. 2236.

Corporation) paid dividends to the holders of its common stock in the form of fractional shares of common stock (sometimes called "scrip") for each share of stock held.[1] Such dividends are commonly known as "stock dividends." This practice was adopted by the management of American Founders Trust in order to discount in the present the prospective future profits which American Founders Trust expected to derive from its holdings of the shares of International Securities Corporation and from its options to purchase such shares. The Trust's policy in this regard was expressed as follows in a special report to stockholders as of March 1, 1926:[2]

> The Trust's present policy of paying dividends on the common shares in fractional shares (seventieths) has been determined for the reason that a considerable proportion of earnings are in the form of valuable "rights" to purchase common shares of International Securities Corporation of America, the exercise of which is immediate only to a relatively small extent. Rather than to sell these rights in the market in order to provide cash for common dividend purposes, thereby sacrificing an excellent investment asset and probably large appreciation thereon, it has seemed wise to retain them and to declare dividends of fractional common shares. Arrangements effected by the Trust for the maintenance of a ready cash market for the "seventieths" protect the interests of the common shareholders who prefer cash income on their shares.

American Founders Trust's holdings of the stock of International Securities Corporation of America (originally International Securities Trust of America) and its options for the future purchase of additional shares of stock of International Securities Corporation of America, were acquired by American Founders Trust as compensation for serving as "fiscal agent" for International Securities Trust of America from 1922 onwards, pursuant to the terms of a contract between the two trusts.[3] At the end of 1926 the contract between International Securities Trust of America and American Founders Trust was altered. Thereafter, American Founders Trust was to receive its compensation for its services as fiscal agent to International Securities Trust of America, in cash instead of in the form of options to purchase International Securities Trust's shares at low prices, as had been done up to that time.[4] As consideration for this alteration in its contract rights, American Founders Corporation was permitted to purchase from International Securities Corporation of America 600,000 shares of Class B stock, especially created and issued for that purpose, at $3.70 a share.[5]

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[1] Public Examination, American General Corporation, et al., Commission's Exhibit No. X4265.

The rate of payment was as follows: 1925, at 1/70 per share per quarter; 1926, same; 1927, same; 1928, at 1/140 per share per quarter; 1929, at 1/140 per share per quarter, plus extra stock dividend of 10% in June 1929.

Allowance must be made, however, for the fact that there were several split-ups of the common shares, as follows: May 20, 1925, three new common shares for each old share; February 20, 1926, three new common shares for each old share; October 1, 1928, two new common shares for each old share. Consequently, for each share of common stock held prior to May 20, 1925, the stockholder possessed 18 shares of common stock subsequent to October 1, 1928, plus the dividends received in the interim. (Id., Commission's Exhibit No. X3489.)

[2] Id., Commission's Exhibit No. X3463 (p. 31).

[3] For details of the arrangement between International Securities Trust of America and American Founders Trust, see supra, p. 2108 et seq.

[4] Op. cit. supra, note 1, Commission's Exhibit No. X3465.

[5] Ibid.

In setting up this acquisition on the books of American Founders Trust, the management decided that the sum of $2,222,220.00, or $3.70 a share, which the Trust had paid for these shares, did not adequately reflect their value. The shares had a book value of $4.82 a share and an estimated liquidating value of $5.74 a share.[6] There was no quoted market price because these shares were newly issued and had never been traded. In its search for a "fair" value for these shares, the management of American Founders Trust arranged to have the accounting firm of Loomis, Suffern & Fernald, who were the accountants for International Securities Trust of America, prepare an appraisal of the worth of these 600,000 shares of International Securities Trust's Class B stock. Basing its appraisal on a capitalization of earnings during the then current year (1926) and of estimated "projected" earnings for a future five-year period,[7] the firm of Loomis, Suffern & Fernald concluded that a valuation of $7,091,004.00 for the Class B shares as of November 30, 1926, was entirely proper "and produced a conservative result."[8] Thereupon the trustees of American Founders Trust ordered that a value of $7,000,000 or $11.67 per share should be ascribed on the books of the trust to the 600,000 shares of International Securities Corporation of America Class B stock for which the trust had paid $2,222,220, or $3.70 a share.[9] An additional sum of $2,457,671.37 was then added to the price paid for the shares, on the theory that this portion of the trust's expenses was properly allocable to the service it performed for International Securities Corporation of America, for which the 600,000 Class B shares were intended to compensate.[10] The cost of these shares was thus fixed at $4,679,891.37, as against a book value of $7,000,000, leaving a book surplus of $2,320,108.63 which was set up as an "unrealized profits" account.[11] The following year, 95,214 shares of this block

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[6] Id., at 22776.

[7] W. H. Conkling, testifying as to the basis of the valuation, stated (id., at 26690): "It was based on an averaging of all earnings of a single year, capitalized; projected earnings over a subsequent five-year period, capitalized."

[8] Id., Commission's Exhibit No. X3517. W. H. Conkling, member of the firm of Loomis, Suffern & Fernald, which submitted this appraisal, testified that by present standards it is entirely outside the function of accountants to attempt to appraise or make independent valuations. He testified (id., at 26696):

> Q. What do you consider the function of an accountant or auditor in connection with the making of an appraisal of stock?
>
> * * * * * * *
>
> A. We are not valuers, we are not appraisers. It is not our function to appraise or make independent valuations. We think that is out of the province of certified public accountants.
>
> Q. I assume you had a different view some years ago?
>
> A. Yes, I did.
>
> Q. Why does your point of view differ today from what it was, Mr. Conkling, back in 1927?
>
> A. I don't know that I can recite all of the various developments that have brought us to the conclusion that we are not really qualified as valuers except the experience and judgment as we grew older and realized that there was much more to consideration of value than lay within our work. For instance, economic factors which have to be considered and which we, as accountants, realize we are not qualified economists always. We are not market judges, and those things we realize must be taken into consideration in connection with valuations, and perhaps years ago we did not realize that so much as we have in more recent years.
>
> Q. In other words, the tendency is more and more to have accountants concerned mainly with the accurate recording of facts.
>
> A. That is right.

[9] Id., Commission's Exhibit No. X4264.

[10] Ibid.

[11] Id., Commission's Exhibit No. X3465 (p. 11).

of 600,000 shares was sold by American Founders Trust to its stockholders, and the balance of 504,786 shares was again revalued, this time at $20 a share, thus carrying an additional $3,792,042.92 to "unrealized profits" account.[12]

In a similar manner, of 600,000 shares of Second International Securities Corporation Class B stock purchased by American Founders Trust in 1926 for $3 a share, 500,000 shares remaining in the portfolio in 1928 were "revalued" at $14 a share, and $5,366,686 was thereby credited to "unrealized profits" account.[13]

The total thus recorded by American Founders in its "unrealized profits" account aggregated $11,478,837.86.[14]

Having thus created by a few strokes of the bookkeeper's pen "unrealized profits" in excess of $11,000,000, the management of American Founders Trust sought to pass these profits on to their stock-

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[12] Id., Commission's Exhibit No. X4264.

[13] This $5,366,686 "bookkeeping profit" resulted after charging $159,973.57 of expenses to the cost of the shares. For itemization of this sum, see note 14, infra.

[14] The details concerning these unrealized profits are shown in the following table (op. cit. supra, note 1, Commission's Exhibit No. X4264):

INTERNATIONAL SECURITIES CORPORATION OF AMERICA CLASS B SHARES

Fiscal year ended Nov. 30, 1926:			
Original purchase cash price, 600,000 sh. @ $3.7037	$2, 222, 220. 00		
Add—selling, operating, and interest expenses deducted from 1924–1925–1926 operations and added to original purchase cost	2, 457, 671. 37		
Total cost ($7.799819 per share)		$4, 679, 891. 37	
Revaluation, 600,000 shares, from above cost value to appraised value, at $11.6667 per share		7, 000, 000. 00	
Amount carried to unrealized profits account			$2, 320, 108. 63
Fiscal year ended Nov. 30, 1927:			
Balance of account, 600,000 shares, carried forward at		7, 000, 000. 00	
Deduct—sales of 95,214 shares (deducted at book value)		1, 189, 558. 57	
Balance, 504,786 shares		5, 810, 441. 43	
Add—selling, operating expenses deducted from 1927 current operations		493, 235. 65	
Total		6, 303, 677. 08	
Revaluation, 504,786 shares from above value to new appraised value of $20 per share		10, 095, 720. 00	
Additional amount carried to unrealized surplus account			3, 792, 042. 92
Total, gross, carried to unrealized profits account with relation to I. S. C. A. Class B shares			6, 112, 151. 55

SECOND INTERNATIONAL SECURITIES CORPORATION CLASS B SHARES

Fiscal year ended Nov. 30, 1926:			
Original purchase cash price, 600,000 sh. @ $3.00	$1, 800, 000. 00		
Add—selling and operating expenses deducted from current operations and added to original purchase price	23, 198. 24		
Balance of account, end of fiscal period	1, 823, 198. 24		
Fiscal year ended Nov. 30, 1927:			
Add—selling and operating expenses deducted from current operations and added to original purchase price	136, 775. 33		
Total costs ($3.2666 per share)	1, 959, 973. 57		
Fiscal year ended Nov. 30, 1928:			
Less—sales 100,000 shares; cost of said sales	326, 659. 88		
Balance of account, 500,000 shares		$1, 633, 313. 69	
Revaluation, 500,000 shares, to $14.00 per share		7, 000, 000. 00	
Amount carried to unrealized profits account			$5, 366, 686. 31
Total, gross, contained in unrealized profits account			11, 478, 837. 86

holders in the form of dividends. The attorneys for the trust, Messrs. Seibert and Riggs, advised, however, that "no cash dividend should ever be declared from unrealized profits" but "stock dividends could be declared from unrealized profits, if the declaration of trust so provided." [15]

Accordingly, although American Founders Corporation had been paying stock dividends since 1925, in December 1926 the declaration of trust of American Founders Trust was amended to provide explicitly that stock dividends might be paid.[16] Periodic stock dividends were thereafter declared each year, and were charged solely against the "Unrealized Profits" account created in the manner recounted above.[17]

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[15] Id., at 26805.

[16] Id., Company's Exhibit No. 9 (a) (quoting Art. III, Sec. 3 (E)). The amendment read: "* * * The Trustees from time to time in their discretion out of the net earings and/or net profits of the Trust, realized or unrealized, and out of the surplus created by increased valuations of the assets of the Trust, whether such valuations be consummated by sale or otherwise, may declare as share dividends, additional shares and/or fractions of additional shares of beneficial interest in the Trust, payable quarterly or otherwise in their discretion, by the declaration, amount and payment of each such dividend in shares, and whether such share dividend in shares shall be declared and charged against realized or unrealized net profits and/or surplus shall be wholly within the descretion of the Trustees."

[17] For the rate at which stock dividends were declared, see note 1, supra. The amounts charged against unrealized profits account are discussed infra, p. 2381.

Apart from legal considerations, many authorities view stock dividends from unrealized surplus with strong disfavor. Dewing, *Financial Policy of Corporations*, 3rd rev. ed. 1934, p. 643, states: "The first principle that should control the declaration of a stock dividend is that the actual net assets—after all reasonable deductions for depreciation and special reserves—shall be appreciably more than the outstanding stock. This means that neither the plant assets, nor the goodwill account, nor any 'revaluation' assets should be marked up in order to show an increase of value other than through the actual reinvestment of surplus earnings in the business. The bookkeeping procedure in connection with the declaration of a stock dividend should consist merely of a transfer from the surplus account—accumulated through annual profits—of an amount sufficient to cover the new issue of stock. * * * Whether or not earnings shall be reinvested in property or paid out in dividends is merely a matter of business judgment. But that there must be actual earnings to do either is fundamentally a matter of simple business honesty, to be expressed outwardly in the accounts. It is not a matter of judgment or expediency or anything of the kind, but a matter of truth."

Kerrigan, "Limitations on Stock Dividends" (1937), 12 Accounting Rev. 238, 246: "Accordingly, unrealized-appreciation surplus has no sound reason in its favor as a basis for recurrent stock dividends, even though legally permissible. As to large occasional stock dividends the use of unrealized appreciation surplus for this purpose is objectionable for a number of reasons."

Ballantine and Hills, "Corporate Capital and Restrictions upon Dividends" (1935), 10 Accounting Rev. 246, 263: "Careful limitations should be placed by statute upon the declaration of dividends in shares of the corporation, in view of the false impressions which may be created by such dividends * * *. Share dividends do not distribute assets or affect the safety of creditors, but they often promise increased dividends, influence the market price of shares and so affect the interests of investors and purchasers of shares. * * * All a board of directors has to do is to adopt a resolution that such assets have a fair value to the corporation in excess of the amount at which they are carried on the books and reciting what such estimated value is and causing it to be entered upon the books. By this magic they will create 'an excess of assets' which the corporation may apply to a dividend in shares."

Despite these valid considerations, courts and legislatures in many states have apparently upheld the right of corporations to declare stock dividends from unrealized appreciation or appraisal surplus, although prohibiting payment of cash dividends from this source. (See: Weiner and Bonbright, Anglo-American Dividend Law; Surplus and Profit, 1930, 30 Col. Law Rev. 954, 981; Ballantine and Hills, loc. cit. supra, p. 263; Kerrigan, loc. cit. supra, p. 244.) Decisions indicating that stock dividends from such surplus may be prohibited are not, however, entirely lacking. (See: *Cole* v. *Adams*, 19 Tex. App. 507, 49 S. W. 1052 (1898); *Pontiac Packing Co.* v. *Hancock*, 257 Mich. 45, 241 N. W. 268 (1931); and *Whitlock* v. *Alexander*, 160 N. C. 465, 76 S. E. 538 (1912).) So far, apparently only two states have expressly interdicted

In 1928, however, American Founders Trust was converted into a corporation under the laws of Maryland. Mr. Riggs, counsel to the system, thereupon (under date of June 13, 1928) advised the management of American Founders Corporation that "we believe it improper for a *corporation* to declare either a cash or a stock dividend out of *unrealized* profits or against the increased valuation of assets written upon the books, without there being a charge against the realized earnings or surplus of the corporation." [18]

In a subsequent opinion dated November 9, 1928, replying specifically to the query "May stock dividends be charged against unrealized profits or appreciation of securities not yet sold, or must they be charged against realized profits or surplus?" Messrs. Seibert & Riggs, counsel of American Founders Corporation, advised definitely that stock dividends should be charged to *realized* net profits "and not the unrealized profits or a surplus caused by a revaluation of securities." [19] The opinion also stated: [20]

Here [the Maryland statute] is the distinct statement that a stock dividend is a capitalization of surplus or net profits, and the question, therefore, is

by statute the payment of stock dividends from unrealized surplus. These states are California (California Civil Code, sec. 346a) and Minnesota (Minnesota Business Corporation Act, sec. 21).

It is highly questionable on two grounds whether the statutes and judicial decisions permitting issuance of stock dividends out of unrealized appreciation would apply to the course followed by American Founders Trust, as described above: (a) the write-up of the securities by American Founders was based not on market values but on an appraisal, the soundness of which was subject to attack; (b) the assets which were written-up were not *fixed assets*, as was true in almost all the adjudicated cases, but were *securities*.

In the *Pontiac Packing Co.* case, supra, although relief was barred by the statute of limitations, the court sustained an objection to a stock dividend from a surplus obtained when the company fictitiously wrote-up the carrying value of a leasehold to more than six times its previous value in order to create a book surplus from which a 150% stock dividend was declared. And in *Whitlock* v. *Alexander*, supra, the court stated that if the directors "have declared and issued stock for it by an excessive over-valuation of property or by an excessive and entirely unwarranted estimate of the profits or the unearned increment, this would be evidence from which fraud might be inferred, and in extreme cases, it might * * * be regarded as conclusive."

Respecting the distinction between write-ups of fixed assets and current assets such as securities, Kerrigan, loc. cit. supra, (p. 246, note 47) states: "Most instances of asset write-up pertain to so-called fixed assets. As to availability of stock dividends based on unrealized appreciation of current assets, the point does not seem to have come before the courts. The statutes are silent on this point, though many of the recently revised corporation acts expressly exclude such source as a basis for cash dividends. By implication, surplus arising from this source is statutorily available for stock dividends. No sound reason, however, occurs to the writer in defense of the practice. The practice should be declared unlawful. In the first place, it must be remembered that allowance of stock dividends out of unrealized appreciation of fixed assets is itself an exception to the recognized principle that dividends be cased on earnings, and even this departure is, as stated above, subject to criticism. In the second place, there is a basic difference between current and fixed assets that justifies positive prohibition in one case and reasonable limitation in the other in regard to the question at hand. As stated by two well-known writers—

"The difference in quality between a fixed asset and a current asset suggests that more liberty ought to be allowed the practice of depleting the unrealized appreciation of a fixed asset than of a current asset, on the theory that the very nature of a current asset contemplates its convertibility into cash within a limited period. Accordingly, there would seem to be little ground for giving any indication whatsoever of unrealized appreciation to current assets—let the deed of conversion tell its own story * * *." Berle, A. A., Jr., and Fisher, F. S., Jr. Elements of the Law of Business Accounting (1932), 32 *Columbia Law Rev.* 592.

[18] Op. cit. supra, note 1, Company's Exhibit No. 9a. Emphasis in original.

[19] Ibid.

[20] Ibid.

whether the phrase "surplus or net profits" is broad enough to include unrealized net profits where a stock dividend is issued against them, where it is admitted that cash dividends cannot be paid. We do not think so, for the reasons time and again advanced.

Despite this opinion, the directors of American Founders Corporation declared quarterly stock dividends of 1/140 a share for each share held in both 1928 and 1929; and in June 1929 they declared an extra stock dividend of 10%. Moreover, in the face of counsel's explicit caveat that if stock dividends were issued they should be charged to surplus or net profits and "that the surplus or net profits to which such charge should be made consists of *realized* surplus and net profits and *not* the unrealized profits or a surplus caused by a revaluation of securities," in 1928 the sum of $433,493.25 and in 1929 the sum of $1,910,191.48 were charged to the unrealized profits account created, as has been recounted, by the revaluation of the Class B shares of International Securities Corporation of America and Second International Securities Corporation owned by American Founders Corporation.[21] However, in conjunction with these charges to unrealized profits, American Founders Corporation gave a perfunctory observance to the principles enunciated in the memorandum of its counsel, by charging the nominal sum of $1 a share against undivided profits.[22]

By the end of 1929, the management of American Founders Corporation took measures to reverse what had been done in connection with the creation of the "unrealized profits" account and payment of stock dividends therefrom. As of November 30, 1929, the entire balance, $8,027,978.99 remaining in the "unrealized profits" account after payment of dividends,[23] was written off. The following year, 1930, the sum of $2,804,661.41, which represented the amount charged in previous years to "unrealized profits" account on account of stock dividends theretofore issued, was charged to undivided profits account, and the unrealized profits account which had been reopened during the year was thereupon completely eliminated.[24] By this time it was, of course, pellucidly clear that the "projected future earnings" on which the accountants had based their appraisal were not materializing according to plan, and the market value of the securities had suffered a considerable shrinkage.

In this manner, correction was ostensibly made of the inflation resulting from the write-up on the company's books of the value of the

[21] Id., Commission's Exhibit No. X4265. The following is a record of the stock dividends charged by American Founders Corporation to "unrealized profits" account created by the revaluation of the Class B shares of International Securities Corporation of America (id., Commission's Exhibit No. X4265):

1925	$27, 384. 82
1926	76, 590. 54
1927	491, 596. 00
1928	433, 493. 25
1929	1, 910, 191. 48
Total	2, 939, 256. 09
Less 1928 adjustments	134, 594. 68
Net	2, 804, 661. 41

[22] Id., Commission's Exhibit No. X4270.

[23] Id., Commission's Exhibit No. X3404–E2 (p. 9).

[24] Id., Commission's Exhibit No. X3405–(A–6a).

International Securities Corporation of America and Second International Securities Corporation Class B stock.[25] This apparent correction was made possible, however, only as the result of another accounting device which the management of American Founders Corporation had employed, in connection with the issuance of the stock dividends. This device, which caused overstatement of the surplus accounts of both American Founders Corporation and United Founders Corporation totaling approximately $24,000,000, entailed charging the shares issued as stock dividends against surplus at an arbitrary sum, less than the paid-in value of these shares at the time, in the manner described below. Solely by virtue of this overstatement of its surplus account, American Founders Corporation was enabled to charge against surplus, for the stock issued as dividends, the sums previously charged to unrealized profits.

b. Overstatement of Surplus Account Through the Device of Charging Stock Dividends at an Arbitrary Figure Less Than Paid-in Value

An important distinguishing feature of a stock dividend is that it converts surplus assets into capital,[26] as compared with a stock split-up which merely subdivides the shares of stock outstanding.[27] Since shares issued as a stock dividend increase the amount of capital stock, it is necessary to ascribe a "consideration to shares so issued." [28] The consideration is found in the amount transferred from surplus to capital stock.[29] How large this amount must be, as a matter of law, and should be, as a matter of sound corporate policy, are questions on which there is a wide range of diversity. Where the stock issued as a dividend is par value stock, substantial agreement exists that the

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[25] No attempt was made, however, to eliminate the $2,363.587.00 which was added to the cost of International Securities Corporation of America Class B stock as "expenses" incurred in the purchase thereof or the approximately $130,000.00 added to the cost of the Class B shares of Second International Securities Corporation, as previously related. (See note 14, supra.)

[26] "A stock dividend is a conversion of surplus or undivided profits into capital stock, which is distributed to shareholders in lieu of a cash dividend." (*United States* v. *Seigel, et al.*, 52 Fed. (2d) 65 (1931).) "* * * the conversion of surplus assets into strict capital * * * is one of the distinguishing characteristics of a stock dividend." (*Harding* v. *Staples* (in re Medd's Estate), 111 Conn. 325, 149 Atl. 846 (1930); see 11 Fletcher, *Cyclopedia Corporations* (1932) Sec. 5362; Paton, editor, *Accountants Handbook* (2nd ed., 1932), p. 940; Dewing, loc. cit. supra, note 17; Kerrigan, loc. cit. supra, note 17; Ballantine and Hills, loc. cit. supra, note 17.)

[27] Paton, loc. cit. supra, note 26; Ballantine and Hills, loc. cit. supra, note 17; May, *Twenty-five Years of Accounting Responsibility* (1936), vol. 2, p. 385: "In our judgment, however, when additional shares of capital stock without par value are issued without any contemporaneous allocation to capital of funds not previously a part of the capital of the corporation, the transaction is a splitting of stock, or multiplication of stock, rather than a stock dividend."

[28] "Authority to declare stock dividends rests upon the general power of a corporation to increase the amount of its capital stock by the issuance of new shares. This power exists by virtue of enabling provisions in the corporate charter or in the statute of the state of incorporation. The right to declare stock dividends is thus fundamentally based on the right to issue new shares." (Kerrigan, loc. cit, supra, note 17, p. 238.) While many states by statute expressly authorize the issuance of stock dividends, Massachusetts prohibits trust companies and public utilities from declaring such dividends, and other states require consent of public service commissions and compliance with restrictive regulations. (Kerrigan, loc. cit. supra, note 17, p. 240; and Fletcher, loc. cit. supra, note 27, p. 901.)

[29] Kerrigan, loc. cit. supra, note 17; Ballantine and Hills, loc. cit. supra, note 17.

capital stock must be increased by an amount transferred from surplus at least equal to the aggregate par value of the dividend shares issued.[30] Where, however, the shares issued as a dividend are no-par shares, the amount of consideration transferred from surplus to capital for the issuance of the shares apparently lies within the discretion of the board of directors, subject to implied or express statutory [31] and charter [32] restrictions. The exercise of this discretion gave rise to such a diversity of practices with respect to the charging of stock dividends,[33] some

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[30] Kerrigan, loc. cit. supra, note 17, p. 248; Ballantine and Hills, loc. city, supra, note 17, p. 264. While existing corporation laws effectuate this principle largely by implication, some eleven states have statutory provisions covering this point. (See Kerrigan, supra.) Paton (loc. cit. supra, note 26), although concurring in the general rule, emphasizes that in cases where there is a paid-in surplus it is necessary to transfer out of earned surplus to capital account, in addition to the par value of the dividend stock, an amount necessary to keep the per-share value of the paid-in surplus undiminished "Paid-in surplus is as much a part of stockholders' contributions as the amount credited to capital stock account, and the two accounts must be considered together in evaluating dividend stock." (Id., p. 941.) The pronouncement of the New York Stock Exchange, set forth infra, is along similar lines, and Kerrigan is also in accord.

[31] "Dividends paid in no-par value shares are also subject to the legal principle that no shares may be issued without a consideration. The amount of the consideration is not, however, as easily determinable as in the case of par value shares. A stock dividend in par value shares must be issued at par, but a no-par stock dividend may be issued at any value specified by the board of directors, subject of course to implied or express statutory or charter provisions on this point. The statutory limitations are of two classes. (1) Some statutes specify a minimum (stated value) below which a share may not be carried, in which case the implication would seem to be that the minimum amount of surplus capitalized must be equal to the aggregate stated value of the dividend shares issued. The effect of a no-par stock dividend on surplus is, under this condition, similar to that of a dividend in shares having par value. (2) Express provision on the point is found in the dividend sections of eleven state statutes. Of this number, eight give the directors wide discretion as to the amount of surplus to be capitalized, if any, and the number of shares to be issued; three provide that the directors shall fix the number of shares and the amount to be capitalized; five provide that the shares shall be carried at such value as shall be fixed by the directors. Of the remaining three, two have constructions which are nearly alike and provide that surplus shall be capitalized to the extent of (a) the amount of preference upon involuntary liquidation of 'preference shares' and (b) the estimated fair value of 'common shares' as determined by the directors. The other statute [Michigan] specifies that the amount capitalized per share must at least be equal to the average original consideration, carried as capital for each share of the given class at the time the dividend is declared. The statutes of only two states (California and Illinois) require that the issuer notify the shareholder of the amount per share transferred to capital stock." (Kerrigan, Limitation on Stock Dividends, 1937, 12 Accounting Rev. 249–50. Authorities cited by the author have been omitted.)

[32] See, for example, Fletcher (loc. cit. supra, note 26, p. 902): "If the charter of a corporation requires it to pay dividends in cash, it cannot declare a stock dividend and compel its shareholders to accept the new stock instead of cash." (Cases cited.)

[33] Paton (loc. cit. supra, note 26, p. 939) states that J. H. B. Hoxsey, Executive Accountant to the Committee on Stock List of the New York Stock Exchange, has indicated nine methods of recording stock dividends which have been reported to the New York Stock Exchange, as follows:

1. No entry affecting capital stock and surplus where no-par stock has no stated value.
2. The transfer of a nominal sum from capital (paid-in) surplus to capital stock.
3. The transfer of an amount equal to the stated or par value of the dividend stock from capital (paid-in) surplus to capital stock.
4. Same as 2 except that transfer is made from earned surplus.
5. Same as 3 except that the transfer is made from earned surplus.
6. The transfer, for each share of dividend stock, of an amount of earned surplus to capital stock, and if any, to capital (paid-in) surplus, equal to the already existing value per share in the two latter accounts.
7. Same as 6 except that the amount transferred is less than the market value per share, and more than the amount transferred under 6.
8. The transfer to capital stock and paid-in surplus of an amount equal to the previously existing book value per share, including in the book value earned surplus.
9. The transfer to capital stock and paid-in surplus of the market value of the dividend stock.

of which were patently unwholesome,[34] that the New York Stock Exchange in 1929 and 1930 made public the reports of its Special Committee on Stock Dividends.[35] The first report concerned itself mainly with the accounting practice to be followed by investment companies *receiving* stock dividends.[36] The second report dealt specifically with the problem of the accounting procedure to be followed by the company *issuing* the stock dividend. It stated: [37]

> * * * The fact that state laws may permit stock dividends to be paid without any charge against earnings or earned surplus or with only a nominal charge has no bearing upon the correct accounting procedure to be followed.
>
> An occasional large split-up, made for convenience in the form of a stock dividend and capitalized at a nominal amount, whether charged against earned surplus or capital surplus is not objectionable, if accompanied by a statement that it is in effect a split-up.
>
> The issuance of periodical stock dividends with either no charge or with an insufficient charge against earnings or earned surplus, while not illegal under the laws of some states, is apt to mislead stockholders and is not regarded as good practice. If such dividends are declared they should be accompanied by a statement clearly indicating either that they are not true earned stock dividends, or, if actually earned but insufficiently charged against earnings or earned surplus, that the method of accounting leaves in earned surplus an amount which may be again used for dividends without further earnings.
>
> In the accounting for stock dividends upon the books of the issuing company, whether for stock with par value or without par value, capital and capital surplus should be regarded together as the consideration, other than earnings, represented by the stock. The sum per share of these two accounts is the minimum amount per share to be issued as a stock dividend, which should be charged against earnings or earned surplus in order that such dividend may be termed a true earned stock dividend properly accounted for and in order that earned surplus may not include a fictitious amount available for further dividends without further earnings.
>
> In cases where there exist substantial uncapitalized assets, tangible or intangible, the amount of the charge against earnings or earned surplus should be larger than this minimum amount.

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[34] See text of second report of the Special Committee on Stock Dividends of the New York Stock Exchange, note 37, infra.

[35] These reports are reprinted in Paton (loc. cit. supra, note 26, pp. 1010–13). See also op. cit. supra, note 1, Commission's Exhibit No. X4266.

[36] This report stated in part "The stock dividend has, in late years, become an important instrument in the financial policy of American corporations, and there can be little doubt that its use is still in the early stages of development.

* * * * * * *

As a matter of definition from the point of view of the Exchange, a true stock dividend represents the capitalization, in whole or in part, of past or current earnings; while a split-up has not of necessity any relation to earnings and may mean nothing more than a change in the form in which ownership in an existing situation is expressed.

* * * * * * *

At the present time, it appears as if the Exchange could go no further than to take the position that it will raise no objection to the method by which investment trusts, holding companies and others account for stock dividends received by them and not realized upon, provided there is the fullest disclosure of the procedure adopted, and provided that these are not included in the income accounts of the receiving companies at a greater dollar value per share than that at which they have been charged to income account or earned surplus account by the paying companies."

[37] Op. cit. supra, note 1, Commission's Exhibit No. X4266.

This pronouncement of the New York Stock Exchange which in effect requires that the paid-in value of the stock issued as a dividend (construing as paid-in value the sum per share of capital and capital surplus) should be charged against earnings or earned surplus, has the support of a large number of authorities, at least as a minimum standard;[38] others variously advocate that the net asset value,[39] or the current market value,[40] of the dividend shares be so charged. The unfortunate consequence resulting from the failure to capitalize stock dividends at a proper sum, alluded to in the report of the New

[38] Paton (loc. cit. supra, note 26, p. 1013) states:

> The recommendation that, from the standpoint of the issuing organization, the charge against earned surplus for a stock dividend declaration should not be less than an amount which reflects the portion of both stated capital and capital surplus allocable pro rata to each share of stock already outstanding times the number of shares issued as a dividend, coincides with the view of many accountants.

The same author states:

> In general it may be said that, in declaring a stock dividend, * * * the rate per share to be capitalized depends upon: (a) the law of the specific jurisdiction, (b) the amount of invested surplus which policy indicates should be capitalized, and (c) the consideration that, broadly speaking, the rate per share should reflect at least the average contributed value of shares already outstanding. (Ibid.) Cf. Michigan General Corporation Law § 22: * * * there shall be transferred to capital at least the equivalent in value per share of such dividend as equals the average original consideration per share of the shares without par value outstanding at the time of such declaration which is carried as capital.

Kerrigan (loc. cit. supra, note 17, p. 250) states:

> It is submitted that in the per share paid-in value of stock, with or without par, is found a sound basis for the amount to capitalize on the occasion of stock dividends. Only through observance of such a standard is it possible to maintain (1) the integrity of the paid-in capital per share, and (2) a rational distinction between stock split-ups and stock dividends. Statutory capitalization provisions should be changed to conform to the principle referred to. Shortly stated, the rule is as follows: The minimum measure of the charge to surplus, should be the sum of the per share capital stock and paid-in surplus to the credit of the class of stock in which additional shares are about to be issued as stock dividends.

[39] Ballantine and Hills state (loc. cit. supra, note 17, p. 264):

> The amount of capitalized surplus should not be less than the aggregate par value of shares issued having a par value and not less than the aggregate of the highest amounts payable on shares without par value in the event of the liquidation, dissolution or winding up of the corporation.

[40] See Graham and Dodd, *Security Analysis* (1934), p. 347. Paton (loc. cit. supra, note 26, p. 940) is authority for the statement that Montgomery prefers making a charge of the amount of the market value of all no par stocks issued as a dividend, whether or not they have a stated value. George O. May has stated:

> In every case the amount of the allocation [for a stock dividend] is necessarily, we think, the amount of the dividend. Though these propositions seem to us almost self-evident, we are aware that they have not been uniformly followed in actual practice. Issues of capital stock which have been termed "stock dividends" have been made without any contemporaneous allocation to capital, and stock dividends have been described in terms inconsistent with the conclusions above reached. In our judgment, however, when additional shares of capital stock without par value are issued without any contemporaneous allocation to capital of funds not previously a part of the capital of the corporation, the transaction is a splitting of stock or multiplication of stock, rather than a stock dividend.
>
> * * * * *
>
> Under the Delaware statute the amount allocated to capital in respect of a stock dividend appears to be in the absolute discretion of the directors. It would apparently be permissible to capitalize, say, 5 cents a share in respect of the stock issued as a dividend even though contemporaneously other stocks were being sold for cash at $100 a share. The effect of this liberality of the law seems to us to be twofold: First, that it imposes on directors a moral responsibility to capitalize a reasonable sum in respect of the dividends which they may declare; secondly, that it imposes on the responsible officers and directors of the corporation the obligation to describe the dividend clearly in terms of the amount a share in respect thereof. * * * Our feeling is that the *burden is normally on directors to justify their action insofar as they capitalize a sum less than the minimum price at which they would consider selling the stock to subscribers*, though we recognize that there may be ample justification for such a course in individual cases. (May, *Twenty-Five Years of Accounting Responsibility*, 1936, vol. 2, pp. 385–6. Emphasis supplied.)

York Stock Exchange, has been the subject of admonitions by many authorities.[41]

The management of American Founders Corporation was explicitly advised both as to the legal problems and the financial and economic considerations involved in their policy of issuing periodic stock dividends. In a formal opinion from their counsel under date of November 9, 1928, it was stated:[42]

The distinction between a stock dividend and a split-up of a no par value stock without any corresponding change in the capital and/or surplus and/or reserves of a corporation is apparent. The fractional dividends of American Founders Corporation are not a stock split-up but a clear stock dividend, and as such in our opinion, under the law of Maryland, require that some reasonable amount representing them be charged against the surplus and/or net profits of the corporation. The statute provides that the actual value of the consideration for the issuance of the stock is taken to be the amount equal to the surplus or net profits capitalized, and if no amount of the surplus or net profits is capitalized, it is obvious that there is no consideration for the issuance of the stock and it is illegally issued.

The amount to be charged against surplus or net profits lies in the discretion of the directors and varies according to the estimate of various companies. It should be reasonable and supported by some reasonable argument.

* * * * * * *

The issuance of no par stock as a stock dividend without any charge to surplus brings up really for determination the question whether there is any consideration for the issuance of such stock, and whether its issuance is valid without any consideration. Upon that point all of the statutes, decisions, and writers are agreed. In some of the states, a fixed minimum must be placed as to the value to be received for no par stock. In others, the amount remains in the discretion of the directors except that it is their duty to obtain what has been called "the equitable minimum", which may be defined as the lowest amount at which a share of stock may be issued without prejudice to the equity of the old shareholders.

In our opinion no par stock under the Maryland law must be issued for some consideration and the statute provides that in the case of a stock dividend, the amount of the consideration is the amount charged to the surplus or net profits.

In our opinion, in order therefore that the stock shall be legally issued and

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[41] See the statements by Kerrigan, Ballantine and Hills, Paton, Dewing, Graham and Dodd, and May, cited supra. See also Berle and Means, *The Modern Corporation and Private Property* (1935), p. 167: "Again, combined with the device of non-par stock, stock dividends may be regularly declared; and (since the directors have full power to determine how much surplus shall be transferred to capital account upon issue of non-par shares as dividends) it may and frequently does occur, that corporations issue dividends payable in stock of their own company, possibly represented in fact by transfer of only a trifling amount of paid-in surplus capital—the result being that the stockholder's pro rata share of assets does not really change, although he has a constantly multiplying number of shares of stock. The securities market does not, as yet, appear sufficiently sophisticated to discount this situation, with the result that serious danger may be involved in purchasing shares of stock in corporations having a paid-in surplus and a policy of regular stock dividends. Such 'stock dividends' apparently constitute a return on the shares; equally they may be thought of as involving no return at all or as representing a return only to the extent that actual profits have been earned and added to capital account." For a clear exposition of the speculative market stimulus furnished by stock dividends, see quotation from Graham and Dodd set forth infra, note 78.

[42] Op. cit. supra, note 1, Company's Exhibit No. 9.

outstanding, there must be a decrease of surplus and increase of capital to some extent as otherwise the stock would be issued without consideration.

The opinion furthermore expressed strong disapproval on policy grounds of the practice of issuing periodic stock dividends without setting a charge against surplus or net earnings "for a reasonable amount," in the following words: [43]

Aside from the legal questions involved, it is obvious that a day of reckoning will come to the shareholders of corporations which consistently issue stock dividends, thus increasing in a compounding manner the amount of stock outstanding and which does not set a charge against surplus or net profits for a reasonable amount. It is a method of paying dividends by which the corporation has its cake, i. e., a surplus available for distribution, and eats it, too, i. e., it gives the shareholders something as a dividend. It is equally obvious that unless there be a steady and consistent appreciation in the earnings of the corporation, the consistent dilution of its stock will decrease the amount earned per share and bring about a fall in the stock unless it is artificially supported.

The principle that the sum capitalized upon the issuance of stock dividends ought not to be less than the paid-in value of the dividend shares was recognized and affirmed by W. H. Conkling, of Loomis, Suffern & Fernald, auditors during the period in question for American Founders Corporation, and "Consulting Accountants" for United Founders Corporation, in his testimony, as follows: [44]

Q. Mr. Conkling, where stock dividends are issued, on what basis would you say they should be set up in crediting surplus?

* * * * * * *

A. Charged to surplus by the issuing company?

Q. Yes.

A. I can't give you a single unqualified answer on that.

Q. What is the better practice?

A. In the first place, before I can answer that I will have to say, is it par-value or no par value stock?

Q. No par value stock.

A. No par value stock. What I believe is the best practice is to charge surplus at the average value of the shares previously outstanding before the stock dividend, but that is not a set rule. I understand your question to me to be what I would prefer or what I think is the best practice.

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[43] Ibid. The opinion concluded as follows:

We are of the opinion:

(1) That American Founders Corporation should charge to its surplus or net profits some consideration for the issuance of the no-par common shares issued as a stock dividend.

(2) That the surplus or net profits to which such charge should be made consists of realized surplus or net profits and not the unrealized profits or a surplus caused by a revaluation of securities.

(3) That the amount of the charge rests in the fair discretion of the directors, subject only to the proviso that there should be no abuse of the power injurious to the existing equity of the stockholders.

(4) That the directors may, in their discretion, authorize an arbitrary amount per share to be charged against surplus or net profits or may adopt any other computation considered by them to be reasonable.

(5) That it is to the advantage of the creditors that such a charge should be made as the capital of the corporation is thereby increased and that the existing common shareholders cannot complain that the consideration for which the shares are issued is inadequate because all of them share equally and pro rata in the distribution, just as if they had received rights to subscribe to the stock at less than its existing market value.

[44] Id., at 26738.

Q. That is exactly what I meant, Mr. Conkling.

A. I think the best practice is to have no dilution in the value of the stock.

* * * * * * *

By Mr. Riggs [of counsel to the Founders Companies]:

Q. You mean the average par value arising from dividing the outstanding shares into the capital of the corporation at the time?

A. Yes.

That the management of American Founders Corporation likewise recognized this general principle of sound accounting and financial procedure is evidenced by its early practice in regard to stock issued as dividends.[45] Nevertheless, despite this recognition by the Founders management, its accountants and its counsel, the practice of American Founders Corporation in this regard was marked by a steady regression from acknowledgedly sound practice, and an ever-wider opening of the door to the abuses recognized to attend departure from the principle of adequate capitalization of stock dividends.

Prior to October 1928, American Founders Corporation, upon the issuance of stock dividends, transferred to capital account a sum equal to the approximate book value of the shares issued as such dividends.[46] Although, as has been pointed out in the preceding section, these sums were charged to "unrealized profits" account and subsequently had to be retroactively corrected and recharged to "surplus," nevertheless the amount capitalized for these stock dividends conformed to sound accounting practice.[47] Moreover, the management saw fit to inform the stockholders concerning the policy of their company, in these words:[48]

* * * share dividend payments are charged against surplus at the approximate book value of the shares.

In October 1928, following its transformation into a corporation, American Founders Corporation modified its practice with respect to capitalization of stock dividends by substituting paid-in value for book value as the basis of capitalization. The resolution of the board of directors[49] ordered that such stock dividends should be charged at "an amount equal to the number of shares represented by such scrip taken at the amount per share resulting from the division of the entire amount paid in for the common stock of the corporation by the number of shares outstanding."

Although the standard of paid-in value established by this resolution entailed a smaller charge to surplus than that of book value, it nevertheless conformed to the minimum requirements of sound accounting practice.[50]

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[45] Discussed infra.

[46] Op. cit. supra, note 1, Commission's Exhibit No. X3466a (p. 11).

[47] Inasmuch as during the years 1925–1928 American Founders Corporation had substantial realized profits, the book value of its shares exceeded their paid-in value. The sums capitalized for stock issued as dividends were, therefore, greater than those which the recognized minimum standard of paid-in value would have required.

[48] Annual Report of American Founders Trust for the fiscal year ended November 30, 1927. (Op. cit. supra, note 1, Commission's Exhibit No. X3466a, p. 11.) However, it is to be noted that it was not stated that by "surplus" was meant "unrealized appreciation surplus."

[49] Id., Commission's Exhibit No. X4267.

[50] See discussion of such standards, supra.

Approximately six weeks later, however, meeting on November 30, 1928, the last day of the fiscal year, the executive committee, in contravention of the policy ordered by the board of directors, directed that stock dividends should be capitalized, not at the paid-in value of the stock thus issued, but at the arbitrary sum of $10.50 a share: $9.50 to be charged against unrealized profits and $1 against undistributed profits. Apparently somewhat uneasy concerning this step, the executive committee made it clear on the record that the departure from the practice of charging paid-in value for stock dividends, as embodied in the directors' resolution of October 17, 1928, was intended to be merely temporary, and that it was "the purpose of this Committee to follow from and subsequent to the dividend of February 1, 1929" the procedure stated in the resolution adopted at the meeting of the board of directors held October 17, 1928.[51]

Thus, in the face of the direction of the board of directors that stock dividends should be charged at the paid-in value of the stock,[52] and shortly after receipt from their counsel of an opinion strongly warning that stock dividends should be charged at an amount adequate to insure against "prejudice to the existing equity of stockholders" and that such charge should be made against "realized surplus" or net profits (and not to unrealized profits or a surplus caused by a revaluation of securities),[53] the executive committee ordered such stock dividends to be charged principally against unrealized profits, and at an arbitrary amount entirely unrelated to paid-in value.[54] Although in the 1927 report of American Founders Trust, stockholders were informed that stock issued as dividends was charged against surplus at the approximate book value of the shares, the report to stockholders for the fiscal year ended November 30, 1928, was completely silent on the subject, and no indication was given of any change of policy in this regard.[55]

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[51] The resolution of the executive committee read in part as follows (op. cit. supra, note 1, Commission's Exhibit No. X4268):

> WHEREAS, In accordance with resolution duly adopted at a meeting of the board of directors held September 19, 1928, a dividend of 1/140 share scrip was declared payable on November 1, 1928, and
>
> WHEREAS, by resolution duly adopted at this meeting as a consideration for the issuance thereof an amount equal to $1.00 per share for the number of full common shares issued and the number of full common shares represented by scrip was charged to Undivided Profits of the Corporation; now, therefore, be it
>
> *Resolved*, That the proper officers of the corporation be and they hereby are authorized and directed to set aside an amount equivalent to $9.50 per share for the number of shares represented by such scrip dividend from the Book Surplus or Unrealized Profits of the corporation, and further that if and when said amount so set aside is earned, it shall be considered as Paid-In Common Share Capital; and further be it
>
> *Resolved*, That the foregoing method be in lieu of the procedure stated in the resolution adopted at the meeting of the board of directors held October 17, 1928, which it is the purpose of this Committee to follow from and subsequent to the dividend of February 1, 1929.

[52] Id., Commission's Exhibit No. X4267.

[53] Id., Company's Exhibit No. 9.

[54] The precise paid-in value of the common stock of American Founders Corporation, at the several dates of issue during 1929, was not readily ascertainable. However, as indicated by the table in note 58, infra, paid-in value at the end of 1929 was equivalent to approximately $35.37 a share; but it was undoubtedly considerably lower in the earlier part of the year. As of November 1, 1928, the declared value of the common stock as shown in this table was $65 a share and the market price was $66 a share.

[55] Op. cit. supra, note 1, Commission's Exhibit No. X3404(E1). In the exhibit devoted to "Surplus and Reserves" account, a footnote stated that the increase of $4,834,306.76 in

Instead of reverting subsequently to the practice of charging stock dividends at the paid-in value of the stock, in the manner contemplated by the November 30, 1928, resolution of the executive committee quoted above, the board of directors two weeks later declared a stock dividend of 1/140 of a share payable January 15, 1929, and ordered the shares thus issued to be charged at $9 a share as compared with the previous charge of $10.50 a share.[56] Throughout the year 1929, this rate of capitalization for the stock issued as dividends was maintained, and when at the end of 1929 American Founders Corporation common stock was split three for one, the shares thereafter issued as stock dividends were capitalized at one-third the former rate, or at $3 a share.[57]

Total paid-in value of the shares issued as stock dividends in 1929 and 1930 aggregated $14,662,849, and total market value of such shares was $32,909,795.[58] Total charge against surplus (both undivided profits account and unrealized profits account) for these

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book surplus during the year was "after deducting $433,493.25 transferred to common capital on account of issuance of scrip dividends." No reference was made as to the number of shares issued as dividends or the amount per share charged.

[56] Id., Commission's Exhibit No. X4269. The $9 charge was directed to be divided $1 to undivided profits and $8 to "book surplus" or unrealized profits.

[57] Id., Commission's Exhibit No. X4270.

[58] The results of American Founders Corporation's revised policy with respect to charging stock dividends are indicated in the following table (id., Commission's Exhibit No. X4270), wherein are compared approximate paid-in values, declared values, market values, and the amounts actually charged to unrealized profits and to surplus accounts.

Issues of dividend shares by American Founders Corporation

Date of issue of dividend shares	Rate per common share	Number of dividend shares issued	Approximate paid-in value	Approximate current declared value		Approximate current market value	
				Per share	Total	Per share	Total
1928							
Nov. 1	1/140	11, 020–106/140		$65.00	$716, 365.00	$66.00	$727, 386.00
1929							
Feb. 1	1/140	11, 373–120/140		65.00	739, 310.00	85.00	966, 790.00
May 1	1/140	12, 889–71/140		65.00	837, 850.00	96.375	1, 242, 273.75
June 10	10%	181, 703–14/140		86.59	15, 733, 662.00	101.125	18, 374, 715.00
Aug. 1	1/140	15, 485–102/140		99.08	1, 534, 352.88	111.625	1, 728, 624.75
Nov. 1	1/140	17, 321–116/140		90.00	1, 558, 980.00	101	1, 749, 522.00
Total, 1928 and 1929		249, 794–109/140	$8, 835, 249				24, 789, 311.50
1930 [a]							
Feb. 1	1/70	120, 824–28/70			No current issues except dividend shares.	27.25	3, 292, 464.90
May 1	1/70	122, 744–66/70				21.50	2, 639, 016.28
Aug. 1	1/70	124, 486–51/70				11.50	1, 431, 597.38
Nov. 1	1/70	126, 234–12/70				6.00	757, 405.02
Adjustments		3/140					
Total, 1930		494, 290–37/140	5, 827, 600				8, 120, 483.58
Grand Totals		744, 085–6/140	14, 662, 849		21, 120, 519.88		32, 909, 795.08

(Footnote 58 continued on p. 2390)

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shares, however, was $3,747,551.82.[59] Measured by market values, as advocated by some authorities,[60] the amount transferred to capital from surplus for the shares issued as stock dividends was deficient by $29,162,244; measured by the minimum standard of paid-in values, the deficiency of capitalization was approximately $10,915,298.[61]

The financial report of American Founders Corporation, as of November 30, 1930, showed undivided profits equal to $8,186,809.[62] Had the $10,915,298 deficiency (on the basis of paid-in values) been charged, the stockholders would have been presented, in place of a surplus, with a deficit of approximately $2,728,489.

United Founders Corporation, with respect to stock dividends, followed a practice similar to that evolved by American Founders Corporation. United Founders Corporation paid no dividends in cash; from the outset it adopted that practice of paying all dividends in the form of fractional shares of stock. In all, five such dividends

Date of issue of dividend shares	Actual charges to Surplus Accounts					
	Charged to undivided profits		Charged to unrealized profits [b]		Total charged to surplus accounts	
	Per share	Total	Per share	Total	Per share	Total
1928						
Nov. 1	$1.00	$11,020.76	$9.50	$104,697.23	$10.50	$115,717.99
1929						
Feb. 1	1.00	11,373.85	8.00	90,990.87	9.00	102,364.72
May 1	1.00	12,889.33	8.00	103,114.59	9.00	116,003.92
June 10	1.00	181,703.10	8.00	1,453,624.80	9.00	1,635,327.90
Aug. 1	1.00	15,485.73	8.00	123,885.84	9.00	139,371.57
Nov. 1	1.00	17,321.83	8.00	138,574.70	9.00	155,896.53
Total, 1928 and 1929		249,794.60		2,014,888.03		2,264,682.63
1930 [a]						
Feb. 1	3.00	362,473.20		None	3.00	362,473.20
May 1	3.00	368,234.82			3.00	368,234.82
Aug. 1	3.00	373,460.19			3.00	373,460.19
Nov. 1	3.00	378,702.51			3.00	378,702.51
Adjustments		(1.53)				(1.53)
Total, 1930		1,482,869.19				1,482,869.19
Grand Totals		1,732,663.79		2,014,888.03		3,747,551.82

[a] The shares listed as issued in 1930 are new shares, there being a three-for-one split up of common shares on November 16, 1929. Accordingly the $3 amount charged to Surplus Account in 1930 is equivalent to $9 per old share, and the amounts shown as market values per share in 1930, are to be multiplied by 3 for a comparison with the market prices in 1929.

[b] As has been explained in a previous section, subsequently all amounts charged to unrealized profits were recharged to surplus account.

[59] Ibid.

[60] See note 40, supra.

[61] Based on paid-in values, the deficiency was as follows:

Total paid-in value of dividend shares issued	$14,662,849
Total charge to undivided profits account (surplus for same)	3,747,551
Deficiency of charges	10,915,298

[62] Op. cit. supra, note 1, Commission's Exhibit No. X3404 (E4), p. 13.

were paid.[63] The initial stock dividend at the rate of 1/70 a share was declared November 6, 1929, payable January 2, 1930; $10 a share was transferred from surplus account to capital, and this rate was consistently maintained in the case of all subsequent dividends despite varying paid-in values and market values. At the time the initial $10 charge was authorized, paid-in value of the stock was approximately $33.84 a share and market value was approximately $44.50 a share.[64]

The total paid-in value of the shares issued as dividends by United Founders Corporation was $18,553,623, while the total amount capitalized was $5,444,675, making a deficiency of charge to surplus (based on the paid-in value) equal to $13,108,948.[65]

United Founders Corporation, in its report to stockholders as of November 30, 1930,[66] showed a balance in undivided profits account of $12,831,834, which, as in the case of American Founders Corporation, would have been completely wiped out had an adequate transfer been made from surplus to capital for the stock issued as dividends.

Thus, by virtue of charging stock dividends at an inadequate sum, the Founders management during the critical years 1929–1930 in effect overstated the surplus of American Founders Corporation by $10,915,298 and that of United Founders Corporation by $13,108,948, or a total of $24,024,246, measured by paid-in values. Measured by market values, surplus accounts of the two companies were overstated by $38,263,893.

Moreover, information accorded to the stockholders of American Founders Corporation and United Founders Corporation concerning the amount capitalized on issuance of stock dividends was of such meager character that even the rare stockholder who was aware of the nature and significance of the principle involved, would have

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[63] The stock dividend figures for United Founders Corporation are shown in the following table (id., Commission's Exhibit No. X4272):

Issues of Dividend Shares by United Founders Corporation

Ex-dividend rate	Date of issue of dividend shares	Rate per capital share	Number of common dividend shares issued	Charged to surplus account at $10 per share	Approximate market value		Approximate paid-in value	
					Per share	Total	Per share	Total
1929 Nov. 30	*1930* Jan. 2	1/70	86, 137–20/70	$861, 372. 86	$44. 50	$3, 833, 109. 21	$33. 84+	$2, 915, 438. 07
1930 Mar. 12	Apr. 1	1/70	88, 181–53/70	881, 817. 57	42. 62½	3, 758, 747. 39	33. 06+	2, 915, 403. 52
May 31	July 1	1/70	121, 825–43/70	1, 218, 256. 14	30. 00	3, 654, 768. 43	34. 539	4, 207, 734. 89
Sept. 2	Oct. 1	1/70	123, 361–38/70	1, 233, 615. 43	17. 12½	2, 112, 566. 42	34. 44+	4, 248. 670. 23
Nov. 30	*1931* Jan. 2	1/70	124, 961–22/70	1, 249. 613. 14	9. 50	1, 187, 132. 49	34. 14+	4, 266, 376. 71
Totals			458, 330–16/70	4, 583, 302. 28		10. 713, 214. 73		15, 638, 185. 35
Grand Totals			544, 467–36/70	5. 444, 675. 14		14, 546, 323. 94		18, 553, 623. 42

[64] Id., Commission's Exhibit No. X4272.

[65] Ibid.

[66] Id., Commission's Exhibit No. X3420(E5) (p. 13).

experienced the greatest difficulty in ascertaining the practice followed by the two companies.[67]

As has already been indicated, when American Founders Corporation was capitalizing stock dividends on the sound basis of "book value," stockholders were clearly informed to that effect; but when, at the end of 1928, this practice was abandoned and replaced by that of capitalizing an arbitrary sum having no relation either to paid-in value or market value, the report to stockholders gave no indication that any change had occurred.

The report of American Founders Corporation for the fiscal year ended November 30, 1929, likewise maintained complete silence as to the course which was followed, although in this year alone the charge to surplus was deficient by approximately $6,600,000 based on paid-in values and $22,500,000 based on market values.[68]

The procedure followed by United Founders Corporation with respect to informing stockholders of the company's practice was similar to that of American Founders Corporation. In the 1929 report of the corporation, since the dividend had been declared but not paid prior to the year-end, it appeared as a liability on the balance sheet in the following form:[69] "Dividends declared November 6, 1929, payable January 2, 1930—$861,372.86." The number of shares issued as dividends was not indicated anywhere in the report, thus rendering computation difficult even for the persistent stockholder determined to learn the amount at which stock dividends were capitalized.[70] Consequently, stockholders had no way of knowing that, measured by the standard of paid-in value, the liability for stock dividends was inadequate by $2,054,065.[71] Subsequently, however, at the annual meeting of the stockholders of United Founders Corporation held March 10, 1930, in the address of the president (later printed and distributed to stockholders)[72] it was stated that $10 a share had been charged

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[67] All authorities are in accord as to the importance of clearly advising stockholders concerning the amount capitalized upon the issuance of stock dividends, and the nature of the surplus account from which the transfer is made. (See authorities cited in notes 26–41, supra.) California and Illinois by statute require that the issuer of a stock dividend notify the shareholder of the amount per share transferred to capital stock. California, Illinois, Minnesota, and Ohio require that dividends (whether cash or stock) from paid-in surplus be accompanied by public notice as to the source used.) (See Kerrigan, "Limitations on Stock Dividends," loc. cit. supra, note 31.)

[68] Op. cit. supra, note 1, Commission's Exhibit No. X4272. In the 1929 report of American Founders Corporation (id., Commission's Exhibit No. X3404–E2) the sole reference to the capitalization of stock dividends was to be found in the exhibit devoted to analysis of the "Surplus and Reserves" account. A decrease of $9,386,410.62 was shown for the year in book surplus, and a footnote stated: "From the balances at the beginning of the year of Book Surplus and Preferred Share Dividend Reserve arising therefrom amounting to $9,938,170.47, there has been transferred to common capital on account of issuance of stock dividends during the year an amount of $1,910,191.48, and the remaining balance totaling $8,027,978.99 have been written off at the end of the year." On the basis of this footnote, a stockholder obviously could not calculate even for himself the amount per share capitalized for stock dividends.

[69] Id., Commission's Exhibit No. X3420(E2) (p. 11).

[70] Such a computation was not, however, impossible. The stockholder who was sufficiently informed in financial matters could multiply the number of shares outstanding by the dividend rate (1/70 a share) and thereby determine the number of dividend shares issued which amount could then be divided into the sum of $861,372.86 stated in the report as the liability for such shares.

[71] See schedule in note 63, supra.

[72] Op. cit. supra, note 1, Commission's Exhibit No. X3843 (p. 13).

against the income of the company for the stock issued as the dividend declared November 5, 1929, and payable January 2, 1930. "The effect of it," the president added, "is equivalent to granting stockholders the right to buy such additional stock at that price."

Despite the employment by the Founders companies of accounting and financial practices in regard to stock dividends which he acknowledged were not consonant with "the best practice,"[73] and despite the complete silence of the reports and the accountants' certificates on the subject, W. H. Conkling, of Loomis, Suffern & Fernald, accountants for the companies, disclaimed any responsibility, because "we have no choice in that." Mr. Conkling testified:[74]

Q. What I am concerned with, Mr. Conkling, we so thoroughly agree with the principle that you have announced that we would like to know, leaving out the question what might be legally permissible, how there can be any other principle that might be deemed sound accounting.

*   *   *   *   *   *   *

A. * * * In all such cases of stock dividends, accountants have to follow the decision of the board of directors, and we have no choice in that. The board of directors determine as to what they shall do. The accountants don't.

Brief reference must be made to one other aspect of the stock dividend policy of the Founders companies, namely, the speculative impetus afforded by this policy to the market action of the Founders stock. American Founders Corporation, for the fiscal year ended November 30, 1929, reported earnings of $4.59 a share of common.[75] Since the artificial character of these earnings, as exposed in Part One of this report, was unknown to the investing public, the effect of these reported substantial earnings was probably stimulating.[76] This stimulus was greatly increased, however, by the stock dividends distributed during the year by American Founders Corporation. The stock dividends paid during 1929 by American Founders Corporation on each share of common stock had an aggregate value to the recipients, based on current market prices at the time of their issuance, of approximately $13.00 a share,[77] or almost three times the amount purportedly earned per share of common by the corporation. Stockholders and investing public may well have been influenced in their calculations as to the worth of the stock more by the fact that it "paid" the equivalent of $13.00 a share in 1929, than by the fact that the stock "earned" $4.59 a share. Such calculations would necessarily result in higher prices for the stock, which in turn would increase the market value of future stock dividends, which once again would stimulate the market action of the stock, and so on in an upward spiral.[78]

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[73] See testimony of Mr. Conkling, supra.

[74] Op. cit. supra, note 1, at 26740.

[75] Id., Commission's Exhibit No. X3404(E2).

[76] American Founders Corporation common stock at the start of the year 1929 sold on the market at $84⅝—$87.50, rose to a high of $122⅞ in September and ultimately sank to a low, in March 1935, of 56¢ a share (making allowance for a three-for-one split-up in November 1929). United Founders Corporation common stock, from a high of $75.50 a share in 1929, sank to a low of 25¢ a share in March 1935.

[77] See schedule in note 58, supra, for stock dividends issued during 1929 by American Founders Corporation and market prices at date of issue.

[78] For a discussion of the "vicious circle" resulting from the issuance of periodic stock dividends, see Graham and Dodd, *Security Analysis,* 1934, pp. 344–9, where the authors

Instead of cautioning against this danger, the Founders' management actually gave encouragement and impetus to the dangerous trend. For example, Louis H. Seagrave, president of American Founders Corporation, in his letter to stockholders accompanying the corporation's annual report for the year 1929, stated:[79]

I have previously stated my belief that shares in American Founders Corporation should be owned outright and considered as an investment, and that for this reason the temporary fluctuations of market quotations might be disregarded. For purposes of comparison, however, it is interesting to consider the benefits accrued to shareholders on a basis of market quotations at the beginning and end of the fiscal year and benefits accrued from rights and stock dividends on a market price basis.

Holders of American Founders Corporation Common Stock during the fiscal year 1929 benefited per share of (old) stock as follows, on the basis of November 30 market quotations:

Cash dividends and quarterly stock dividends (taking stock at market of 93; equivalent to 31 on the present shares)	$3.15
Value, if exercised, of rights to subscribe at $65 per share to additional common shares, one for each eight shares held of record January 15, 1929	3.50
Value of 10% stock dividend received in June	10.46
Value, if exercised, of rights to subscribe to United States Electric Power Corporation common at $15 per share, one for two and one-half shares American Founders common of record September 14, 1929	2.25
Total	$19.36

Adding to the above the appreciation of $25 per share (increase in market quotation of November 30, 1929, over December 1, 1928), there was a total gain on the investment per share of $44.36. On the basis of $68 per share, the market quotation of December 1, 1928, and additional investments required by the exercise of rights offered during the fiscal year, this represents a gain of 53.52 percent on the investment.

* * * * * * *

The earnings of the Corporation as given in the report do not, of course, take into consideration unrealized appreciation. However, it is interesting and rather significant to note the amount per share of unrealized earnings, both separately

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state: "Nearly every financial practice is open to abuse and periodic stock dividends have proved no exception. The objectionable feature in this case has been to establish a regular stock dividend rate exceeding in *market value* the amount of the earnings carried to surplus. This practice makes the issue appear unduly attractive to the unintelligent buyer who is deceived by the high cash value of the current payments in stock. It requires some insight into corporate accounting methods to realize the significance of such stock-dividend payments. * * * An arrangement of this kind is likely to develop into a vicious circle. The higher the market price the greater the apparent value of the stock dividends, which in turn will seem to justify a still higher market price. (With a 10% stock dividend the dividend return obviously remains at 10% regardless of how high the market may climb.) Such a result is deceptive and supplies an unwholesome impetus to riotous speculations, as well as to thoughtless investment." The authors conclude that "the abuses of the periodic stock dividend policy may readily be prevented by the simple rule that stock dividends at *market value* must not exceed the earnings available for dividends."

[79] Op. cit. supra, note 1, Commission's Exhibit No. X3404–E2.

and in combination with the cash earnings (not consolidated) of the Corporation as a parent company.

The total holdings of the Corporation, taken at market quotations of November 30, 1929, showed an appreciation during the fiscal year of $18,148,413. Before allowing for taxes thereon, but after allowing for Preferred Dividend Reserve, this amounts to $8 per share on the average number of Common shares outstanding during the year. As indicated under "Earnings," the amount earned by the Corporation as a parent company per Common share on the average number outstanding, after appropriation to Preferred Share Dividend Reserve, was $4.59, which added to the appreciation makes a total of $12.59 per share. Before allowing for Preferred Dividend Reserve this total would be $13.99 per share.

It is evident that both earnings and increased values warranted the conservative distribution made to shareholders during the year.

Thus, not content with nondisclosure of the artificial character of the companies' reported earnings, the Founders management encouraged stockholders and the investing public to "ride the whirlwind" by taking into account such evanescent and deceptive factors as cash value of stock dividends, cash value of "rights," and even unrealized appreciation on portfolio securities.[80]

2. INADEQUATE DISCLOSURE WITH RESPECT TO PUBLISHED CAPITAL SURPLUS ACCOUNTS OF THE FOUNDERS COMPANIES—INFLATION OF SURPLUS ACCOUNT BY SHIFT FROM PREFERRED CAPITAL STOCK ACCOUNT

In the published financial reports of the various Founders companies, correlated details were not furnished as to the make-up of the capital

[80] Even prior to the period during which the overstatement of the surplus accounts of the Founders companies was effected through inadequate charging out of stock dividends, as described in the foregoing section, the surplus account of American Founders Corporation had been overstated by approximately $900,000 through the practice of charging out inadequate sums for shares issued as compensation to the management. During the years 1923–1927 there was in force a contract between American Founders Corporation (then Trust) and the controlling management group, consisting of Christopher F. Coombs, William R. Bull. Frank B. Erwin (and, later, Louis H. Seagrave) whereby the managers received no cash salaries but were compensated by the issuance to them of common stock at nominal prices which varied according to the total capital raised by the trust from year to year. Prior to the abrogation of this agreement in 1927, the managers had acquired from the trust 124,875 shares (allowing for split-ups) of common stock at an average cost of $1.67 per share. (Id., Commission's Exhibits Nos. X5489, X3549, and X3550.) The market value of these shares had reached $73 each at the time the agreement was canceled. (Id., Commission's Exhibit No. X3489.) Other acquisitions by the managers increased their holdings to 214,475 shares, a number equal to 30% of the total common shares then outstanding. (Id., Commission's Exhibit No. X3403.)

In capitalizing the shares issued to the management, American Founders Trust assigned to them only a nominal value during the years 1924–1926. In 1927, the shares issued during that year were capitalized at their approximate book value, but no attempt was made to correct the overstatement of surplus accounts which had been effected during the prior years, which overstatement amounted to more than $860,000.

Nothing in the American Founders Corporation reports afforded stockholders even an intimation that approximately one-third of the total outstanding common stock had been issued by the company to the managers at nominal prices, far below market prices or book values, and that through inadequate capitalization of these shares the surplus accounts of the company had been overstated by more than $860,000. (Id., Commission's Exhibits Nos. X3463, X3465, and X3466A.)

surplus accounts of the respective companies.[1] Accordingly, stockholders could not ascertain from these reports the manner of creation of the capital surplus, its composition, or the charges previously entered against it.

For example, the balance sheet of United Founders Corporation, as at November 30, 1930, as set forth in the financial report to stockholders, stated the capital stock and capital surplus accounts of United Founders Corporation as follows:[2]

Capital stock, no par value, common, issued and outstanding (including scrip), 8,774,033–26/70 shares	$150, 286, 752. 20
Capital surplus	36, 216, 061. 81

It was not disclosed to the stockholders, either in this report or in previous reports, that the 8,774,033–26/70 shares of outstanding common stock, set up in the report at $150,286,752.20 had actually been issued for $298,730,094.43.[3] Thus, it was not disclosed that of this amount, the sum of only $150,286,752.20 was allocated to capital stock account, as shown above, and the remainder of $148,443,342.23 was credited to capital surplus account.[4] Accordingly, common stockholders were not informed that only about 50% of the funds paid into the corporation's treasury by them became capital of the corporation, while the remainder was constituted a paid-in surplus.[5]

As indicated above, capital surplus was reported in the statement at $36,216,061.81 without statement or explanation of any kind. In two respects this report was deficient: first, the source of this capital sur-

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[1] For example, see reports of International Securities Corporation of America (Public Examination, American General Corporation, et al., Commission's Exhibit No. X3401); American Founders Corporation (id., Commission's Exhibit No. X3404); United Founders Corporation (id., Commission's Exhibit No. X3420).

[2] Id., Commission's Exhibit No. X3420 (E5).

[3] Id., Commission's Exhibit No. X3421 (A4 and A5).

[4] Ibid.

[5] Unregulated creation and use of paid-in surplus is viewed critically by many authorities. For example, Berle and Means state (*The Modern Corporation and Private Property,* 1935, p. 168):

> The real danger inherent in "paid-in surplus" appears where the corporation has more than one class of stock outstanding. Under the law, so far as at present developed, paid-in surplus is, *prima facie,* available for all the purposes for which other surplus can be used. It can apparently be paid out as dividends at the will of the directors, despite the fact that it is really a contribution of assets and not an accumulation of earnings.
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> * * * * * * *
>
> Paid-in surplus is dangerous because in large measure the public investor neither knows of the existence nor understands what it means. He may be contributing surplus without knowing it.

See also: Weiner, "The Amount Available for Dividends where No-Par Shares Have Been Issued," 1929, 29 Columbia Law Rev., p. 906; Kerrigan, "Limitations on Stock Dividends," 1937, 12 Accounting Rev., p. 239; Ballantine and Hills, "Corporate Capital and Restrictions upon Dividends," 1935, 10 Accounting Rev., p. 246.

The more carefully drawn modern statutes have, however, distinguished between earned surplus and paid-in surplus, and earned surplus is made the basis or source of dividends upon common shares. Earned surplus is defined as the undistributed earnings either from the date of organization or from some date of reorganization or recapitalization. (Cal. Civ. Code, sec. 299; Ill. Bus. Corp. Act (1933), sec. 19; Minn. Bus. Corp. Act (1933), sec. 20; Pa. Bus. Corp. Law (1933), sec. 614). Illinois prohibits any dividend out of paid-in surplus except as a dividend on preferred stock (sec. 41). California, Illinois, Minnesota and Ohio require that dividends from paid-in surplus be accompanied by public notice as to the source used. (See Ballantine and Hills, "Corporate Capital and Restrictions upon Dividends," 1935, 10 Accounting Rev., p. 255.

plus was not revealed; second, it was not revealed that the amount of $36,216,061.81 stated as capital surplus represented a balance from the original (paid-in) capital surplus, which had equaled $148,443,342.23.[6] The reduction from original capital surplus to the sum of $36,216,061 shown as surplus in the report, had been brought about by two charges aggregating $112,227,280.42 against surplus: (1) a deduction of $1,-850,323, representing selling commissions and other distributing costs;[7] and (2) a deduction of $110,376,956.92 representing "United Founders' proportion of excess of cost of shares of subsidiary companies over their stated values, arising through exchange of shares. * * *"[8]

Similar deficiencies marked the published financial reports of American Founders Corporation. For example, the balance sheet in the report of American Founders Corporation as of November 30, 1929,[9] set the sum of $61,922,006.69 against "Capital Stock, Common (No Par Value)—8,446,694–32/140 shares (including scrip)," and it stated capital surplus at $37,668,688.80. Nowhere in this report, or in previous reports, were the stockholders informed that the sum originally paid in upon issuance of the 8,446,694–32/140 shares of common stock was $100,639,025.09,[10] of which sum only $61,922,006.69 was allocated, as shown above, to capital stock account, and the balance of $38,717,018.40 was set up as capital surplus.[11] Neither the manner in which capital surplus was reduced from the original sum of $38,717,018.40 to the $37,668,688.80 shown in the 1929 report, nor even the fact of such reduction, was in any fashion stated or explained. The actual composition of capital surplus account, concerning which stockholders were kept in ignorance, was as follows:[12]

Capital paid in on common stock	$38, 717, 018. 40
Premiums on preferred capital stock	63, 120.11
Surplus arising from sale of treasury shares	807, 067. 37
Total	39, 587, 205. 88
Deduct—Commissions paid out for sales of capital shares, of which amount the sum of $936,861 was paid out as commission at 6% on the preferred stock of the par value of $15,614,350 sold in the 1929 fiscal period	1, 918, 517. 08
Amount published	37, 668, 688. 80

It will be noted from the above itemization that the sum of $1,918,517.08, representing financing costs, had been charged against

[6] Under the Securities Act of 1933, an issuer is required to disclose the "* * * surplus of the issuer showing how and from what sources such surplus was created." [Securities Act of 1933, Schedule A (25).] See also Form A–1, p. 32, and Instruction Book for Form A–2, p. 46, for the schedules and details required by the Commission under the Securities Act of 1933.

[7] Public Examination, American General Corporation, et al., Commission's Exhibit No. X3421A (8B).

[8] Reference had been made to this latter deduction in the semi-annual report of May 31, 1930, but the annual report as of November 30, 1930, was silent on the subject. (Id., Commission's Exhibit No. X3420 (E4 and E5).

[9] Id., Commission's Exhibit No. X3404 (E2).

[10] Id., Commission's Exhibit No. X3405 (A4 and A5 (b)).

[11] Ibid.

[12] Id., Commission's Exhibit No. X3405 (A5).

capital surplus account, and that included in this sum was $936,861 paid out as commissions on the sale of preferred stock of the corporation during 1929, the current year of the report. By charging this sum against capital surplus without indication thereof in the 1929 report, the management and accountants of American Founders Corporation effectually concealed from stockholders this expenditure of $936,861 resulting from the corporation's current financing operations.

Of even greater consequence, however, was the nondisclosure in the published reports and the accountants' certificates of the manner in which the management of American Founders Corporation in 1929 bolstered the capital surplus account of the corporation in the sum of $7,499,100 by shifting that sum from preferred-stock account to capital-surplus account. This shift is better understood when the composition of the amount stated to have been allocated to capital surplus is considered. This amount, it has been stated, before deductions and adjustments (as shown above), equaled $38,717,018.40. It was comprised of the following items:[13]

Paid in prior to October 1, 1928 (pertains to American Founders Trust)	$1, 680, 257. 75
Paid in on sales for cash:	
1928	1, 000, 000. 00
1929	14, 097, 100. 65
Allocated to capital surplus upon exchanges of American Founders Corporation common stock for capital shares of subsidiary companies, 1929	14, 440, 560. 00
Allocated to capital surplus upon conversion of preferred stock	7, 499, 100. 00
Total	38, 717, 018. 40

The circumstances in which the sum of $7,499,100 was added to capital surplus were these: In June and July 1929 there was sold to the public an issue of allotment certificates representing units of preferred stock of American Founders Corporation, each unit being comprised of two shares of preferred stock of the par value of $50 a share total par value $100 a unit. Each of these units was convertible, at the option of the holders, until a specified date, into one share of common stock without par value. Shortly after issuance of these allotment certificates, the market price of the common stock passed $100 a share.[14] Thereafter, during the remainder of the 1929 fiscal yeriod, holders of 149,982 of the units exercised their options to convert them into 149,982 shares of common stock.[15] For each share of common stock issued in place of a unit which comprised two shares of preferred stock with total par value of $100, the management and accountants of American Founders Corporation credited to common capital stock account only one-half of $100, or $50 a share.[16] The remaining $50 a share, which had previously

[13] Id., Commission's Exhibit No. X3405 (A5b).
[14] Id., Commission's Exhibit No. X3773.
[15] Id., Commission's Exhibit No. X3405 (A4).
[16] Id., Commission's Exhibit No. X3405 (A4a).

been credited to preferred stock capital account, was then shifted to capital-surplus account.[17] Thus, of the $14,998,200 which had previously been credited to preferred capital-stock account for the 149,982 units ($299,964 shares preferred) at $100 a unit (or $50 for each share of preferred), only 50% thereof, or $7,499,100, was credited to common capital-stock account, while the remaining $7,499,-100 was added to capital-surplus account before the close of the 1929 fiscal period. Notwithstanding the obvious importance of this transformation of $7,499,100 from capital-stock liability into capital surplus, the published reports of the corporation, as well as the accountants' certificates, were completely silent on the subject.

As a result of the Founders companies' practice of furnishing no details with respect to their capital-surplus accounts, there remained a vast area of financial territory[18] in which the management was able to maneuver, as has been shown, with complete inscrutability.

3. CONCEALMENT IN PUBLISHED REPORTS AND AT STOCKHOLDERS' MEETINGS OF PAYMENT BY THREE FOUNDERS COMPANIES OF $1,100,000 IN SETTLEMENT OF THREATENED STOCKHOLDERS' SUIT

In 1931, United Founders Corporation, American Founders Corporation and Founders General Corporation paid out in cash and stock the sum of $1,100,000, in settlement of a threatened stockholders' suit against the three Founders companies and certain of their officers and directors. On this subject, the following agreed statement of facts was read into the record:[1]

On or about March 1931, Messrs. Donovan and Raichle[2] threatened to bring suit on behalf of Founders Holding Company, Inc.,[3] and others,[4] in which some of the citizens of Buffalo were stockholders, against United Founders Corporation, American Founders Corporation, and Founders General Corporation, E. Stanley Glines, C. Foster Coombs, Thomas H. Benton, and Louis H. Seagrave.

A draft of the proposed complaint was furnished to counsel for the United Founders Corporation. In this draft it was alleged that the plaintiff had decided to dispose of its stock of United Founders Corporation, and that it was deterred from disposing of it by representations made to the plaintiff by the defendants. Among the alleged representations were that the asset value of

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[17] Id., Commission's Exhibit No. X3405 (A5b).

[18] In the case of United Founders Corporation, it will be recalled, the capital surplus account was originally set up at $148,443,342.23, and in the case of American Founders Corporation at $38,717,018.40, or a total of $187,160,360.63.

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[1] Public Examination, American General Corporation, et al, at 2666-3.

[2] Law firm representing the prospective plaintiffs.

[3] Founders Holding Company, Inc., was not a company in or affiliated with the United Founders Corporation system, but was a separate and distinct investment-holding company formed by V. M. Ericson, Inc., and others.

[4] These others were: J. M. Ericson, Inc., Joseph M. Ericson, Cleveland G. Babcock, Ward G. Blackmon, Howard C. Laverack, William P. Haines, W. Grant King, Edgar H. Sackett, and Morris S. Tremaine. (Op. cit. supra, note 1, Commission's Exhibit No. X4254.)

the stock was misrepresented; that plaintiff had large bank loans secured by the pledge of its stock and that had it not been for these representations, it would have been able to have sold the collateral and paid off the loan, and that by reason of these representations it retained its stock, to its damage.

A specific allegation was that the defendant, Glines, had reiterated these representations and emphatically urged that the plaintiff would be making a grave mistake in disposing of its holdings in United Founders Corporation.

The proposed action, which was for alleged losses of upwards of $4,250,000 was settled by a payment of $1,100,000, consisting of $700,000 cash and the delivery of 50,000 shares of common of United Founders Corporation, which shares had a market of $8 per share. I would like to add there the complaint was never served.

* * * * * * *

The 50,000 shares of United Founders Corporation were paid by Founders General Corporation out of its own portfolio.[5] Founders General Corporation, in addition contributed $100,000 in cash,[6] American Founders Corporation and United Founders Corporation each contributed $300,000 in cash.[7] The transaction in question is referred to in the minutes of special meeting of the Board of Directors of American Founders Corporation held April 6, 1931, Exhibit No. 4256, but there is no record that these minutes were submitted for approval by the stockholders at any annual meeting of the stockholders * * *[8]

The Founders management and accountants treated the payments made in settlement of this threatened litigation in a manner calculated to suppress effectively from the investing public and stockholders all knowledge of the subject. The accounting processes by which the payments were concealed from the stockholders were as follows: The boards of directors of all three companies ordered first that there should be transferred in each case a sum, equal to the respective settlement payment, from the undivided surplus account of each company to newly created "special reserve" accounts.[9] The boards then ordered that the settlement payments be charged to these "special reserve" accounts, thus causing them to be closed out as soon as they were opened.[10] No justification existed in accounting practice for the creation of these "special reserves," as nothing with respect to the settlement payments remained contingent or unknown, to be cleared up in the future, and the claim had been fully liquidated and definitely disposed of. It cannot be doubted, therefore, that the sole purpose of the accounting procedure adopted by the Founders management was to cast a veil about the subject of the settlement payments in order that it might effectively be concealed from stockholders and the investing public. How fully this aim was achieved is evidenced by the "Statement of Consolidated Surplus and Undi-

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[5] Id., Commission's Exhibit No. X4254.

[6] Ibid.

[7] Id., Commission's Exhibits Nos. X4256 and X4257.

[8] Id., Commission's Exhibits Nos. X4258 and X4259.

[9] Id., Commission's Exhibits Nos. X4254, X4256, and X4257.

[10] Ibid.

vided Profits and Reserves" of United Founders Corporation as of November 30, 1931.[11]

The settlement payment made by United Founders Corporation was $300,000 and that of American Founders Corporation was a like sum,

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[11] This statement, as included in the published report of the corporation for the year ended 1931, was as follows (id., Commission's Exhibit No. X3420–E7):

Report of United Founders Corporation

EXHIBIT II

UNITED FOUNDERS CORPORATION

STATEMENT OF CONSOLIDATED SURPLUS AND UNDIVIDED PROFITS AND RESERVES NOVEMBER 30, 1931

Surplus and Undivided Profits:		
Balances, December 1, 1930:		
Capital Surplus	$36, 216, 061. 81	
Undivided Profits	12, 831, 834. 26	
Interest in Undivided Profits of Subsidiary Companies	4, 050, 006. 50	
Interest in Bond Interest and Preferred Share Dividend Reserves of Subsidiary Companies	2, 897, 774. 30	
		$55, 995, 676. 87
Add:		
Balance of Income for the year ended November 30, 1931 Exhibit III	1, 172, 277. 40	
Gain on Retirement of Debentures acquired below par	993, 747. 52	
Gain on Retirement of preferred shares acquired below par	95, 046. 21	
Amount credited to Capital Surplus from issuance of 125,000 Common shares	437, 500. 00	
Increase in Bond Interest and Preferred Share Dividend Reserves through additional appropriations by American Founders Corporation and its Subsidiaries and through increased percentage of ownership in Subsidiary Companies	100, 140. 48	
		2, 798, 711. 61
		58, 794, 388. 48
Deduct: Appropriations for Reserves (see statement below)		26, 930, 797. 72
Balances, November 30, 1931:		
Capital Surplus	$22, 189, 784. 26	
Undivided Profits	4, 516, 081. 23	
Interest in Undivided Profits of Subsidiary Companies	2, 159, 810. 49	
Interest in Bond Interest and Preferred Share Dividend Reserves of Subsidiary Companies	2, 997, 914. 78	
Total Surplus and Undivided Profits—Exhibit I		31, 863, 590. 76
Reserves:		
Balances, December 1, 1930		13, 652, 723. 55
Appropriations during year:		
Chargeable, as shown above, to United Founders Consolidated Surplus and Undivided Profits	$26, 930, 797. 72	
Chargeable as reduction of United Founders interest in Earned Surplus of Subsidiaries at dates of acquisition	6, 393, 174. 44	
Chargeable to Minority Interests	3, 337, 951. 13	
		36, 661, 923. 29
		50, 314, 646. 84
Less: United Founders portion of balance of reserves of Investment Trust Associates at date of its liquidation		3, 303, 922. 41
		47, 010, 724. 43
Deduct:		
Net losses sustained during year (including loss of $14,384,761.47 sustained by United Founders Corporation due to liquidation of Investment Trust Associates), charged to reserves appropriated as follows:		
From Current gains on retirement of Debentures and Preferred Shares	$1, 088, 793. 73	
From prior gains on retirement of Debentures and Preferred Shares	535, 442. 17	
From Capital Surplus of United Founders Corporation	14, 036, 565. 69	
From Consolidated Undivided Profits	14, 442, 527. 27	
From Undivided Profits of Subsidiaries, which reserves were applied against the United Founders interest in Earned Surplus at dates of acquisition	6, 385, 072. 66	
From Minority interest	4, 947, 219. 18	
		41, 435, 620. 70
Balances of Reserves, November 30, 1931—Exhibit I		5, 575, 103. 73

NOTE: On November 30, 1931 the unrealized depreciation from book value—cost less reserve—of all investments at then current market quotations (or as otherwise indicated on page 21 of this report)

making a total of $600,000 to be accounted for.[12] It will be noted that after Surplus and Undivided Profits there appears: "Deduct—appropriations for Reserves (see statement below) * * * $26,930,-797.72." It is in this item that the $600,000 settlement payments of United Founders Corporation and American Founders Corporation are included.[13] Reference to that part of the statement which purported to give further details concerning Reserves [14] reveals only that Reserves equaled $13,652,723 at the start of the year, and that further "Appropriations during the year" to Reserve account equaled $36,-661,923, making a total of $50,314,646. In the course of the year, deductions totaling $41,435,620 were made. Lumped in these deductions of $41,435,620 were the settlement payments totaling $600,000 made by United Founders Corporation and American Founders Corporation. These deductions from Reserves were identified in the report merely as "Net Losses sustained during year." In this manner, payments in settlement of threatened litigation made by these investment companies were reported to stockholders as "net losses sustained during the year," thereby assimilating them to losses on sales of securities [15] and effectively concealing their true character.

American Founders Corporation resorted to a procedure identical with that described above for United Founders Corporation, in order to conceal the settlement payment of $300,000 made by it.[16] Founders General Corporation, however, with respect to its settlement payment of $500,000 in cash and stock, found it unnecessary to resort to any circumventions, since, despite the fact that Founders General Corporation was a wholly owned subsidiary of American Founders Corporation, its accounts were not consolidated with those of its parent, and it made public no financial report. By virtue of the relationship of American Founders Corporation and Founders General Corporation, the cost of the settlement to American Founders Corporation was actually $800,000, or 73% of the total sum involved, as against $300,000, or 27% of the total, for United Founders Corporation.

To what extent this arrangement represented an equitable division of liability between these two companies was a question which the Founders management never permitted to come before the general body

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exceeded the unrealized depreciation as of November 30, 1930 by $52,859,562.52. After allowing for minority interests, the amount applicable to United Founders Corporation was $40,667,796.28.

By using then current market quotations (or as otherwise indicated on page 21 of this report) except for holdings of United States Electric Power Corporation which are valued at their consolidated book value of $14.77 per share, the unrealized depreciation as of November 30, 1931 exceeded the unrealized depreciation as of November 30, 1930, calculated on a similar basis (using a consolidated book value of $14.31 per share for holdings of United States Electric Power Corporation), by $32,928,690.29. After allowing for minority interests, the amount applicable to United Founders Corporation was $21,292,-175.17. LOOMIS, SUFFERN & FERNALD.

[12] At this period the accounts of American Founders Corporation were consolidated in the statement of United Founders Corporation.

[13] Testimony of Lawrence P. Carron, former treasurer of the two companies. (Op. cit. supra, note 1, at 26666.)

[14] See note 11, supra.

[15] The impression that "Net losses sustained during the year" were investment losses was further strengthened by the following statement which appeared in the letter of the president prefacing the report (op. cit. supra, note 1, Commission's Exhibit No. X3420, E7): "Charges to Reserves. Net losses sustained during the fiscal year were charged to reserves appropriated from surplus as shown in Exhibit II. It will be noted that the Statement of Income (Exhibit III) shows only income received from interest and dividends, profit on syndicate participations, investment service fees and other income, and does not contain any items of profit or loss on the sale of securities."

[16] Id., at 26667 and Commission's Exhibit No. X3404 (E6), p. 10.

of stockholders of the respective companies for consideration. That the subject was never directly presented to the stockholders for their approval need hardly be stated in view of the aforementioned measures adopted by the management with respect to the financial reports in order to conceal the settlement payments. In addition, the Founders management took precautions to ensure that the subject should not come to the knowledge of the stockholders in indirect fashion. Although the minutes of all directors' meetings held during the year were invariably presented for the examination of stockholders at their annual meeting, the minutes of the directors' meeting of April 6, 1931, containing the details of the threatened litigation and the settlement payments, alone among all the minutes for the entire period, were withheld from the stockholders.[17]

Lawrence P. Carron, treasurer of United Founders Corporation and American Founders Corporation, testified as follows concerning the manner in which the settlement payments were treated in the reports of the company:[18]

Q. Mr. Carron, there was no way in which anyone could have told from the manner in which these settlements were handled and these settlements and payments were made, that they were made, unless reference were made to the minute books of the company, isn't that correct?

A. That is so. You could tell these payments included in the aggregate, but you could not tell what the payment was made for.

Q. The reports did not disclose the fact this large sum had been paid in settlement of litigation?

A. That is right.

Q. Or threats at litigation?

A. That is right.

Franklin Bowman, member of the firm of Haskins & Sells, who were "consulting accountants" at the time for American Founders Corporation and United Founders Corporation,[19] when examined with respect to the matter, testified:[20]

Q. There was a settlement here, Mr. Bowman, of a lawsuit against the Corporation and some of its sponsors. Assuming that the directors believed in good faith that the action was unmeritorious, and assuming that they did not want the public to know of an unmeritorious action, which for strategic reasons they had settled, do you think that that should be permitted by the accountants to be recorded in such a way that the fact that a substantial sum of money, $1,100,000, had been paid in settlement of the litigation, and so that no one could tell from the balance sheet or profit and loss statement that there had been any such payment?

A. Well, that is pretty hard to answer. My present opinion would be that probably there ought to be something said about it.

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[17] Suppression of the minutes of the April 6 meeting was accomplished in the following manner: The annual stockholders' meetings in 1931 were held April 13. At these meetings the minutes of all directors meetings held since the previous stockholders' meeting (April 14, 1930) *but up to April 2, 1931* were presented. At the subsequent stockholders' meeting held May 13, 1932, only the minutes of directors' meetings held since the date of the previous stockholders' meeting (April 13, 1931) were presented. In this fashion, presentation of the minutes of the directors' meeting of April 6, 1931 was surreptitiously passed over. (Id., Commission's Exhibits Nos. X4258 and X4259.)

[18] Id., at 26667.

[19] Id., Commission's Exhibit No. X4333.

[20] Id., at 26848.

D. The Functions of "Consulting Accountants" to the Founders Companies

Each of the Founders companies, as has previously been stated, employed two firms of accountants, one firm being designated as "auditors" and the other as "consulting accountants."[1] The appearance of the names of two prominent firms of accountants on the companies' financial reports undoubtedly contributed to a feeling of confidence on the part of stockholders and the investing public respecting the correctness of the reports and the soundness of the accounting practices on which these reports were based. That the Founders management believed such confidence would be inspired is evidenced by the emphasis placed on this double "protection for the investor" in the published reports and in advertising literature of the Founders companies.[2]

The two firms of accountants which permitted their names to appear on the Founders' reports as "Consulting Accountants" during the period covered by this report were Loomis, Suffern & Fernald and Haskins & Sells. Representatives of both firms admitted that the names of their firms had in no other instances appeared on corporate financial reports as "consulting accountants." Franklin Bowman, of Haskins & Sells, conceded that the public may have been misled by the appearance of his firm's name as "consulting accountants" and expressed doubt that the firm would ever again permit its name to be thus used.[3]

When examined as to the function of "consulting accountant," H. W. Conkling, of the firm of Loomis, Suffern & Fernald, testified:[4]

> Q. * * * Now, Mr. Conkling, you have listened to my reading of these excerpts which indicate you were one of the two firms of independent accountants on this job and you looked upon yourself as being independent accountants?[5]

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[1] The firms of certified public accountants which served the Founders companies from 1924 to 1935 are listed in note 72, Sec. A, supra.

[2] For example, in an elaborate brochure entitled "The American Founders Group of Companies," published in 1929 by Harris, Forbes & Co. (Public Examination, American General Corporation, et al., Commission's Exhibit No. X4336), under the heading "Safeguards for the Investor," it was stated:

> As stated elsewhere, the books and accounts of each company are audited periodically by Messrs. Loomis, Suffern & Fernald. Each company has retained Messrs. Haskins & Sells as consulting accountants and a representative of that firm is constantly engaged on the company's affairs and conducts a continuous audit of cash and investments. Messrs. Haskins & Sells also make an annual unannounced audit simultaneously for all four companies.

See also excerpts set forth in Sec. A, supra, p. 2220, and testimony of witnesses. For statements in published reports, see Public Examination, American General Corporation, et al., Commission's Exhibits Nos. X3404 and X3420.

[3] Id., at 26827.

[4] Id., at 26670 et seq.

[5] Excerpts read from Founders General Corporation's communication to dealers, dated July 13, 1929 (id., Commission's Exhibit No. X4334), American Founders Bulletin No. 1, August 1929 (id., Commission's Exhibit No. X4335), and booklet "American Founders Group of Companies," published by Harris, Forbes & Co., New York, copyright date March 1929 (id., Commission's Exhibit No. X4336). These excerpts stated substantially (id., Commission's Exhibit No. 4335):

> Protect the Investor
>
> The audits and reports are made for each company by two firms of certified public accountants. One firm, designated as the auditors of the company, prepares the annual balance sheet and income statement which is incorporated in the annual report to shareholders. When the Board so requires, they may also make semi-annual income audits. The other firm of accountants, designated as the company's consulting

A. Yes; we did.

Q. And the certifications you made were made as certifications by independent accountants?

A. Yes, sir.

Q. Had you considered it your duty to append your certification only to papers that accurately presented the affairs for the information of the stockholder?

A. Yes, sir.

Q. In other words, you felt that in a sense you were retained by the company to protect the interest of the stockholders and of the public?

A. To the extent an accountant can do it; yes, sir.

Mr. RIGGS [counsel to the Founders Companies]: Mr. Stern, you don't mean to infer those statements you read were incorrect, do you?

Mr. STERN: No; I think those statements accurately set forth what was intended to be the relationship.

Mr. RIGGS: And it is a fact Haskins & Sells did have a representative in the office at all times checking cash and investments; isn't it, Mr. Conkling?

The WITNESS: It is my understanding; yes, sir.

By Mr. STERN:

Q. Now, Mr. Conkling, just what is a consulting accountant, and what are his functions in this situation?

A. During the period which we were consulting accountants it was our understanding our duties were to consider and advise the company in any matters which were brought to our attention, and on which they wished to have advice.

Q. In other words, if your name was appended to a balance sheet or to a report to the stockholders as consulting accountants, you didn't consider that was a representation to the world of the correctness of that balance sheet.

A. No; we did not.

Q. So that the person who was the auditor made the representation of correctness, and all that the consulting accountant was—were you stating it, "If we were consulted about anything, we would consult and we would give our advice to the best of our ability."

Is that your notion of the consulting accountant?

A. Yes; except that we did review papers and accounts relating to such audits. but we did not make any examination of the books.

Q. Then you were in effect, you did make the representation to the public that so far as the matters appearing in the report of the actual auditors that you had gone over those and you found their analysis of them correct?

A. I think we made no representation.

Mr. RIGGS: Just a moment, Mr. Stern. Do you mean at any time Loomis, Suffern and Fernald held out as consulting accountants?

Mr. STERN: Oh, yes.

Mr. RIGGS: Haskins & Sells. Wait a minute, neither consulting accountants, Haskins & Sells nor Loomis, Suffern and Fernald, would ever certify a balance sheet or earning statement. It would be the auditors who would do the certification after examination of the books. Is that correct?

The WITNESS: That is correct.

Mr. RIGGS: And the consulting accountants were never called upon to verify the balance sheet?

The WITNESS: No, sir.

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accountants, maintain a representative in the office of the company, who has immediate access to the financial records, and reports thereon to the directors.

Each company has appointed Messrs. Loomis, Suffern & Fernald as auditors and Messrs. Haskins & Sells as consulting accountants for the year 1928.

Mr. Riggs: They might be mentioned in the text of the report; they were consulting accountants and their advice could be obtained.

By Mr. Stern:

Q. The only thing I don't understand was what was the public to assume by your name being there as consulting accountants or Haskins & Sells when you were there as auditors?

A. Of course, I am not prepared to say what the public assumed, but I think it represented to them that we were available to act in a consulting capacity on matters which were taken up with us at any time we chose, we were available and employed to act for that purpose as consultants. I don't think it carried any representation that we had made examination of the accounts or that we joined in the certification.

* * * * * * *

By Mr. Riggs:

Q. May I ask, Mr. Conkling, whether you, in permitting the use of your name as consulting accountants, felt some degree protected by the fact that there was a firm of certified public accountants engaged annually as independent auditors?

A. Oh, yes; we would not occupy a position of consulting accountants if there were not independent auditors.

Q. That is what I want to bring out, if the reports were to be made by the companies in the audit or treasury department without any independent audit by an outside firm of certified public accountants, you think the situation would be different than that where there is a firm of independent certified public accountants?

A. Yes; I do. In that case I would not be willing to have our name used in their printed matter or in their reports.

* * * * * * *

Q. Do you recall of any other instance in which your name was used as consulting accountants?

A. No; I do not recall any other instance.

Franklin Bowman, of the firm of Haskins & Sells, when examined as to his firm's function as consulting accountants, testified: [6]

Q. Were you ever in the capacity, or held out to the public in the capacity, of consulting accountant in connection with any companies other than the companies of American Founders Group?

A. Not to my recollection. I would not say that we have not been, but personally I don't know of any other.

Q. Do you think that is a desirable relationship?

A. Well, that would be hard to say. In the light of past experience I think possibly there might be an interpretation that if your name appeared as consulting accountant, you were more or less jointly certifying, although that was not the idea.

Q. And because of that possibility, because the name of Haskins & Sells is a name that would hold out to the public a certain amount of comfort and satisfaction and assurance, you would not like to be in that position?

A. I don't believe I would enter into that sort of an arrangement again, having our name published as Consulting Accountants.

Q. Unless you were joint certifying accountants?

A. Yes.

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[6] Id., at 26827.

Appendix J

CLOSED-END AND OPEN-END INVESTMENT COMPANIES ANALYZED WITH RESPECT TO ACCOUNTING PRACTICES AND REPORTS TO STOCKHOLDERS

Closed-End Investment Companies of the Management Type (62 Companies)

Adams Express Company, The.
American Capital Corporation.
American Cities Power & Light Corporation.
American European Securities Company.
American International Corporation.
American Superpower Corporation.
Bankers Securities Corporation.
Blue Ridge Corporation.
British Type Investors, Inc.
Broad Street Investing Co., Inc., The.
Capital Administration Company, Ltd.
Carriers and General Corporation.
Central-Illinois Securities Corporation.
Central States Electric Corporation.
Chicago Corporation, The.
Commonwealth Securities, Inc.
Crum & Forster Insurance Shares Corporation.
Eastern States Corporation.
Eastern Utilities Investing Corporation.
Electric Power Associates, Inc.
Electric Shareholdings Corporation.
Fourth National Investors Corporation.
General American Investors Company, Inc.
General Capital Corporation.
General Public Service Corporation.
Home and Foreign Securities Corporation.
Illuminating and Power Securities Corporation.
Inter-Continental Corporation.
International Superpower Corporation.
Investment Company of America, The.
Investors Equity Company, Inc.
Italian Superpower Corporation.
Lehman Corporation, The.
Liberty Share Corporation.
M. & T. Securities Corporation.
Mayflower Associates, Inc.
National Bond & Share Corporation.

National Investors Corporation.
Niagara Share Corporation of Maryland.
Oils & Industries, Inc.
Old Colony Investment Trust.
Old Colony Trust Associates.
Pacific Investors, Inc.
Pacific Southern Investors, Inc.
Petroleum Corporation of America.
Phoenix Securities Corporation.
Prudential Investors, Inc.
Public Utilities Corporation.
Railway and Light Securities Company.
Reybarn Company, Inc., The.
Reynolds Investing Company, Inc.
Second National Investors Corporation.
Selected Industries, Inc.
Shawmut Association.
Shawmut Bank Investment Trust.
Third National Investors Corporation.
Tri-Continental Corporation.
United States & Foreign Securities Corporation.
United States & International Securities Corporation.
Utility and Industrial Corporation.
Utility Equities Corporation.
Vick Financial Corporation.

Open-End Investment Companies of the Management Type (14 Companies)

Bullock Fund, Ltd.
Canadian Investment Fund, Ltd.
Dividend Shares, Inc.
Group Securities, Inc.
Incorporated Investors.
Investment Trust Fund A.
Investment Trust Fund B.
Investors Fund C, Inc.
Maryland Fund, Inc., The.
Massachusetts Investors Trust.
Nation-Wide Securities Company.
Quarterly Income Shares, Inc.
Spencer Trask Fund, Inc.
State Street Investment Corporation.

Appendix K

SCHEDULE 1.—*Treatment of Profits and Losses upon sales of securities by closed-end investment trusts and companies as indicated in published reports or in replies to Commission's Questionnaire*

[Classifications under which results were shown in years indicated. An asterisk indicates net losses were realized for the year shown]

Name of company	1927, 1928 and 1929	1930	1931	1932	1933	1934	1935
Adams Express Company, The.	1927: Item not shown (In Questionnaire, in Consolidated Surplus). 1928 and 1929: Income.	Income	Earned Surplus*	Earned Surplus*	Earned Surplus*	Earned Surplus	Capital Surplus.*
American Capital Corporation.	1928: Income (item not segregated). 1929: Revenue (Income).	Revenue (Income)*	Profit and Loss* (In Questionnaire, in Income).	Profit and Loss* (In Questionnaire, in Income).	Revenue (Income)	Revenue (Income)	Revenue (Income).
American Cities Power & Light Corporation.[a] [b]	1928 and 1929 Income.	Income [a]	Certain results to Operating Surplus and certain other results to Capital Surplus.[b]	Operating Surplus*	Earned Surplus and Undistributed Profits.* [a] [b]	Earned Surplus and Undistributed Profits account.	Earned Surplus and Undistributed Profits account.
American European Securities Co.	1927 to 1929 Income	Deduction from net ordinary Income.*	Deduction from net ordinary Income.*	Deduction from net ordinary Income.*	Deduction from net ordinary Income.*	Deduction from net ordinary Income.*	Addition to net ordinary Income.
American International Corporation.[a] [c]	1927* to 1929: In part to Income and in part to Reserve account.[c]	In part to Income and in part to Reserve account.* [c]	Earned Surplus*	Earned Surplus*	Earned Surplus [a]	Earned Surplus	Earned Surplus.
American Superpower Corporation.	1927 to 1929: Income	Income	Income	Income*	Income*	Income*	Reserve for decrease in Market Value of Securities* (allocated Earned and Capital Surplus).

See footnotes at end of table.

SCHEDULE 1.—*Treatment of Profits and Losses upon sales of securities by closed-end investment trusts and companies as indicated in published reports or in replies to Commission's Questionnaire*—Continued

[Classifications under which results were shown in years indicated. An asterisk indicates net losses were realized for the year shown]

Name of company	1927, 1928 and 1929	1930	1931	1932	1933	1934	1935
Bankers Securities Corporation.[d]	1928 and 1929: Item not shown (in Questionnaire, in Income).[d]	Item not shown (in Questionnaire, in Income).[d]	Item not shown (in Questionnaire, in Income).[d]	Item not shown (in Questionnaire, in Income).[d]	Income[d]	Income[d]	Income.[d]
Blue Ridge Corporation.[a]	1929: Earned Surplus, except for portion of losses which was carried to Reserve (allocated Capital Surplus) and which losses were not shown in published report.*	Profits and losses, based on book value, carried to Capital Surplus.*	Profits and losses, based on book value, carried to Capital Surplus.*	Profits and losses, based on book value, carried to Capital Surplus.*[a]	Earned Surplus	Earned Surplus	Earned Surplus.
British Type Investors, Inc., as of Feb. 28.	1928 and 1929: Income.		Deduction from net ordinary Income.*	Deduction from net ordinary Income.*	Capital Surplus*	Capital Surplus*	Capital Surplus.*
Broad Street Investing Co., Inc., The.		Deduction from net ordinary Income* (in Questionnaire, in Capital Surplus).	Special Surplus* Realized Loss on Securities Sold (in footnote) (in Questionnaire, in Capital Surplus).				
Capital Administration Co., Ltd.	1929: Income (in Questionnaire, in Capital Surplus).	Income* (in Questionnaire, in Capital Surplus).	Special account (Realized Profits and losses on Securities Sold)* (in Questionnaire, in Capital Surplus).	Capital Surplus*	Capital Surplus.*	Capital Surplus	Capital Surplus.
Carriers and General Corporation.		Deduction from net ordinary Income.*	Deduction from net ordinary Income.*	Deduction from net ordinary Income.*	Deduction from net ordinary Income.*	Deduction from net ordinary Income.*	Deduction from net ordinary Income.

Central-Illinois Securities Corporation.	----------	Income	Capital Surplus	Capital Surplus*	Capital Surplus	Capital Surplus	Capital Surplus.
Central States Electric Corporation.[e]	1927 to 1929: Income	do	Surplus* [e] (In Questionnaire, in Operating Surplus).	Surplus* (In Questionnaire, in Operating Surplus).	Surplus* [e] (In Questionnaire, in Operating Surplus).	Surplus* (In Questionnaire, in Operating Surplus).	Surplus* (In Questionnaire, in Operating Surplus).
Chicago Corporation, The.	1929: Income	Income*	Reserve for Securities.*	Reserve for Securities.*	Reserve for Securities.	Reserve for Securities.	Reserve for Securities (allocated Combined Surplus).
Commonwealth Securities, Inc.	1928 and 1929: Income.	do*	Operating Surplus*	Operating Surplus*	Operating Surplus*	Operating Surplus*	Operating Surplus.*
Crum & Forster Insurance Shares Corporation.	1928: Item not shown (In Questionnaire, in Income). 1929: Income.	Income	Surplus* (account is of a mixed character).	Surplus* (account is of a mixed character).	Surplus* (account is of a mixed character).	Surplus* (account is of a mixed character).	Surplus* (account is of a mixed character).
Eastern States Corporation.	1927* to 1929: Income.	do	Income*	No report issued (In Questionnaire, in Income).	Earned Surplus*	Earned Surplus*	Earned Surplus.
Eastern Utilities Investing Corporation.	1927: Item not shown (In Questionnaire, in Income). 1928: Income (in a footnote). 1929: Addition to net ordinary Income.	Addition to net ordinary Income.	Earned Surplus	Earned Surplus (In Questionnaire, in Capital Surplus).	No published report* (In Questionnaire, in Capital Surplus).	No published report* (In Questionnaire, in Reserve for Investments).	No published report* (In Questionnaire, in Reserve for Investments) (allocated Combined Surplus).
Electric Power Associates, Inc.[d]	1929: Income	Income [d]	Income [d]	Surplus [d] (In Questionnaire, in Capital Surplus).	Surplus *[d] (In Questionnaire, in Capital Surplus).	Surplus [d] (In Questionnaire, in Capital Surplus).	Surplus [d] (In Questionnaire, in Capital Surplus).

See footnotes at end of table.

SCHEDULE 1.—*Treatment of Profits and Losses upon sales of securities by closed-end investment trusts and companies as indicated in published reports or in replies to Commission's Questionnaire*—Continued

[Classifications under which results were shown in years indicated. An asterisk indicates net losses were realized for the year shown]

Name of company	1927, 1928 and 1929	1930	1931	1932	1933	1934	1935
Electric Shareholdings Corporation.[a]	1929: Income [a]	Income [a]	Surplus* [a] (In Questionnaire, losses in Operating Surplus; profits in Capital Surplus).	Surplus* (In Questionnaire, in Operating Surplus).	Surplus* (In Questionnaire, losses in Operating Surplus; profits in Capital Surplus).	Surplus* (In Questionnaire, in Operating Surplus.)	Surplus (In Questionnaire, profits in both Capital Surplus and Operating Surplus).
Fourth National Investors Corporation.	1929: Income*	Income*	Statement entitled "Security Profits"* (In Questionnaire, in Income).	Statement entitled "Security Profits"* (In Questionnaire, in Income).	Statement entitled "Security Profits"* (In Questionnaire, in Income).	Statement entitled "Security Profits"* (In Questionnaire, in Income).	Statement entitled "Security Profits"* (In Questionnaire, in Income).
General American Investors Co., Inc.	1927 to 1929: Income	Deduction from net ordinary Income.*	Special account under Surplus, Realized Profit on Securities Sold.*	Special account under Surplus, Realized Profit on Securities Sold.*	Special account under Surplus, Realized Profit on Securities Sold.*	Special account under Surplus, Realized Profit on Securities Sold.	Special account under Surplus, Realized Profit on Securities Sold.
General Capital Corporation.	1929: Deduction from net ordinary Income.*	do	Deduction from net ordinary Income.*	Deduction from net ordinary Income.*	Deduction from net ordinary Income.*	Deduction from net ordinary Income.*	Deduction from net-ordinary Income.*
General Public Service Corporation.[a]	1927 to 1929: Income	Income	Income [a]	Earned Surplus*	Earned Surplus*	Earned Surplus*	Earned Surplus.
Home and Foreign Securities Corporation.[a]	1929: Deduction from net Income.*	Deduction from net Income.*	Deduction from net Income.*	Deduction from net Income.*	Income	Income [a]	Addition to net Income.
Illuminating and Power Securities Corporation.	1927 to 1929: Income	Income	Deduction from net ordinary Income.*	Deduction from net ordinary Income.*	Addition to net ordinary Income.	Deduction from net ordinary Income.*	Addition to net ordinary Income.
Inter-Continental Corporation.[a]	1929: No report issued (In Questionnaire, in Income).	No report issued (In Questionnaire, in Income).	No report issued (In Questionnaire, in Paid-in Surplus).*	No report issued (In Questionnaire, in Income).	No report issued (In Questionnaire, in Income).	No report issued (In Questionnaire, in Income).*	No report issued (In Questionnaire, in Income).

International Superpower Corporation (absorbed November 1932).	1929: Income	Deduction from net ordinary Income.*	Deduction from net ordinary Income.*	Deduction from net ordinary Income.*			
Investment Company of America, The.	1927 to 1929: Included in Income (Item not published separately).	Income	Deduction from net ordinary Income.*	Deduction from net ordinary Income.*	Addition to net ordinary Income.	Addition to net ordinary Income.	Addition to net ordinary Income.
Investors Equity Co., Inc.[a] (absorbed May 1932).	1928 and 1929: Income.	do	Reserve for Securities*[a] (allocated Earned Surplus).	Reserve for Securities* (allocated Earned Surplus).			
Italian Superpower Corporation.	1928 and 1929: Income.	do	Income*	Income*	Income*	Income*	Income.*
Lehman Corporation, The.	1929: Deduction from net ordinary Income.*	Deduction from net ordinary Income.*	Deduction from net ordinary Income.*	Deduction from net ordinary Income *	Deduction from net ordinary Income.*	Addition to net ordinary Income.	Addition to net ordinary Income.
Liberty Share Corporation.[d]	1929: Item not shown (In Questionnaire, in Income).[d]	Item not shown (In Questionnaire, in Income).[d]	Item not shown (In Questionnaire, in Income).*[d]	Item not shown (In Questionnaire, in Income).[d]	Item not shown (In Questionnaire, in Income).[d]	Item not shown (In Questionnaire, in Income).[d]	Income.[d]
M. & T. Securities Corporation.[a]	1929: Included in profits and earnings (Item not published separately) (Shown in Questionnaire, in Income).	Included in profits and earnings (Item not published separately) (Shown in Questionnaire, in Income).*	Included in profits and earnings (Item not published separately) (Shown in Questionnaire, in Income).*[a]	Included in profits and earnings (Item not published separately) (Shown in Questionnaire, in Income).*[a]	Included in profits and earnings (Item not published separately) (Shown in Questionnaire, in Income).*[a]	Included in profits and earnings (Item not published separately) (Shown in Questionnaire, in Income).	Included in profits and earnings (Item not published separately) (Shown in Questionnaire, in Income).
Mayflower Associates, Inc.	1929: Income*	Income	Income*	Income*	Income	Income	Income.
National Bond & Share Corporation.	1929: do	Income*	Capital Surplus*	Capital Surplus*	Capital Surplus	Capital Surplus*	Capital Surplus.
National Investors Corporation.	1929: Income	do	Income*	Deduction from net ordinary Income.*	"Security Profits Surplus"* (In Questionnaire, in Income).	"Security Profits Surplus"* (In Questionnaire, in Income).	Statement entitled "Security Profits Surplus" (In Questionnaire, in Income.)

See footnotes at end of table.

SCHEDULE 1.—*Treatment of Profits and Losses upon sales of securities by closed-end investment trusts and companies as indicated in published reports or in replies to Commission's Questionnaire*—Continued

[Classifications under which results were shown in years indicated. An asterisk indicates net losses were realized for the year shown]

Name of company	1927, 1928 and 1929	1930	1931	1932	1933	1934	1935
Niagara Share Corporation of Maryland.	1929: Income (In Questionnaire, in Earned Surplus).	Special Surplus (In Questionnaire, in special account, Realized Investment Profits or Losses).	Capital Surplus* (In Questionnaire, in special account, Realized Investment Profits or Losses).	Capital Surplus*	Capital Surplus*	Capital Surplus*	Capital Surplus.*
Oils & Industries, Inc.[a] (change of name from Oil Shares Incorporated.)	1928 and 1929: Income.	Income	Addition to net ordinary Income.[a]	Deduction from net ordinary Income.*	Deduction from net ordinary Income.*	Addition to net ordinary Income.	Addition to net ordinary Income.
Old Colony Investment Trust.[f]	1928: Income 1929: Addition to net ordinary Income.	Addition to net ordinary Income.	Reserve for Securities.*[f]	Reserve for Securities.*[f]	Reserve for Securities.*[f]	Reserve for Securities.*[f]	Reserve for Securities.*[f]
Old Colony Trust Associates.[a]	1928 and 1929: No Realized Profits or Losses.	Income	Income	Loss reflected in balance sheet as deduction from capital stock account.*		Income [a]	Income.[a]
Pacific Investors, Inc. (established 1934).						Revenue (Income)	Revenue (Income).
Pacific Southern Investors, Inc. (Outgrowth of merger of Pacific Investing Corporation into Southern Bond & Share Corporation in 1932).	1927 to 1929: Revenue (Income).	Revenue (Income)*	Revenue (Income)* (Southern Bond & Share Corp.) Deduction from net ordinary income* (Pacific Investing Corp.)	Revenue (Income)	Revenue (Income)	do	do.

Petroleum Corporation of America.[a]	1929: Paid-in Surplus.	Paid-in Surplus*[a]	Deduction from Surplus-Combined* (In Questionnaire, in Special Surplus, Profit and Loss on Realization of Investments).	Special Surplus (Profit and Loss on Realization of Investments).*	Special Surplus (Profit and Loss on Realization of Investments).	Special Surplus (Profit and Loss on Realization of Investments).	Special Surplus (Profit and Loss on Realization of Investments).
Phoenix Securities Corporation.[d][g]	1929: Income and Capital Surplus.[g]	Income and Capital Surplus.[d][g]	Income and Capital Surplus.*[d][g]	Income and Capital Surplus.*[d][g]	Income and Capital Surplus.[g]	Income and Capital Surplus.*[d][g]	Capital Surplus.
Prudential Investors, Inc.[d]	1929: Income*	Income*[d]	Capital Surplus*[d]	Capital Surplus*[d]	Capital Surplus	Capital Surplus	do.
Public Utilities Corporation.[d]	1927 to 1929: No report issued (In Questionnaire, in Income).	No report issued (In Questionnaire, in Income).	No report issued (In Questionnaire, in Income).*	No report issued (In Questionnaire, in Income).*	No report issued (In Questionnaire, in Income).*	No report issued (In Questionnaire, in Income).*	No report issued (In Questionnaire, in Income).
Railway and Light Securities Co.[a]	1928: Addition to net ordinary Income. 1929: Income	Addition to net ordinary Income.	Earned Surplus	Special Surplus*[d]	Special Surplus	Special Surplus	Special Surplus.
Reybarn Company, Inc., The.[a]	1929: Income	Income*	Reserve for Securities*[a] (allocated Capital Surplus).	Reserve for Securities* (allocated Capital Surplus).	Reserve for Securities* (allocated Capital Surplus).	Reserve for Securities* (allocated Capital Surplus).	Reserve for Securities* (allocated Capital Surplus).
Reynolds Investing Co., Inc.[a][h]	1928: Income 1929: Earnings (Income) (Item not shown separately).	do.	Income*	Income*	Income*	Income*	Earned Surplus[a] (Shown also in Income[h]).
Second National Investors Corporation.	1928: No Realized Profits or Losses. 1929: Income	do.	Statement entitled "Security Profits"* (In Questionnaire, in Income).	Statement entitled "Security Profits"* (In Questionnaire, in Income).	Statement entitled "Security Profits"* (In Questionnaire, in Income).	Statement entitled "Security Profits"* (In Questionnaire, in Income).	Statement entitled "Security Profits"* (In Questionnaire, in Income).
Selected Industries, Inc.[a]	1928 and 1929: Income.	do.	Surplus*[a] (account is of a mixed character).	Surplus* (account is of a mixed character).	Surplus* (account is of a mixed character).	Surplus* (account is of a mixed character).	Surplus (account is of a mixed character).

See footnotes at end of table.

SCHEDULE 1.—*Treatment of Profits and Losses upon sales of securities by closed-end investment trusts and companies as indicated in published reports or in replies to Commission's Questionnaire*—Continued

[Classifications under which results were shown in years indicated. An asterisk indicates net losses were realized for the year shown]

Name of company	1927, 1928 and 1929	1930	1931	1932	1933	1934	1935
Shawmut Association	1928 and 1929: Income.	Income*	Earned Surplus*	Earned Surplus*	Capital Surplus*	Capital Surplus*	Capital Surplus.
Shawmut Bank Investment Trust.	1928 and 1929: Income.	Income	Income*	Deduction from net ordinary Income*.	Deduction from net ordinary Income.*	Deduction from net ordinary Income*.	Addition to net ordinary Income.
Third National Investors Corporation	1929: Income	Income*	Statement entitled "Security Profits"* (In Questionnaire, in Income).	Statement entitled "SecurityProfits"* (In Questionnaire, in Income).	Statement entitled "Security Profits"* (In Questionnaire, in Income).	Statement entitled "Security Profits"* (In Questionnaire, in Income).	Statement entitled "Security Profits"* (In Questionnaire, in Income).
Tri-Continental Corporation.		Earned Surplus	Reserve* (allocated Surplus of a mixed character).	Surplus* (As distinguished from Undistributed Net Income Account).	Surplus* (As distinguished from Undistributed Net Income Account).	Surplus* (As distinguished from Undistributed Net Income Account).	Surplus (As distinguished from Undistributed Net Income Account).
United States & Foreign Securities Corporation.	1927 to 1929: Income	Income*	Income*	Income*	Income*	Income*	Income.
United States & International Securities Corporation.	1928: Income 1929: Income*	do	do	do	do	do	do.
Utility Equities Corporation.[a]	1928 and 1929: Addition to net ordinary Income.	Deduction from net ordinary Income.*	Addition to net ordinary Income.[a]	Addition to net ordinary Income	Deduction from net ordinary Income.*	Addition to net ordinary Income.	Earned Surplus.
Utility and Industrial Corporation.[a]	1929: Income	Income	Income*	Profits to Income; also losses on Securities acquired after Jan. 20, 1932, date of reduction of Capital to Income; if acquired before Jan. 20, 1932, such losses to Capital Surplus.*	Profits to Income; also losses on Securities acquired after Jan. 20, 1932, date of reduction of Capital to Income; if acquired before Jan. 20, 1932, such losses to Capital Surplus.*	Profits to Income. Also losses on Securities acquired after Jan. 20, 1932, date of reduction of Capital to Income; if acquired before Jan. 20, 1932, such losses to Capital Surplus.*	Profits and losses realized after April 2, 1935, date of write-down to Capital Surplus; trading results prior thereto treated as indicated for years 1932 to 1934.[a]

Vick Financial Company.	1929: Income*-------	Income*------------	Reserve for Investments* (allocated Capital Surplus).	Reserve for Investments* (allocated Capital Surplus).	Reserve for Investments (allocated Capital Surplus).	Reserve for Investments* (allocated Capital Surplus).	Reserve for Investments (allocated Capital Surplus).

[a] This company at some time, during the period under review wrote down the carrying value of securities, and the treatment of investment profits and losses was affected by these write-downs. See 2296, and Appendix L. 2420. This symbol is shown also in the years in which the write-downs occurred.

[b] It was the policy of this company to carry securities at the lower of cost or market, or the lower of book or market, at each year-end indicated by this symbol. See p. 2314.

[c] American Cities Power & Light Corporation—In 1931, operating surplus account reflected the losses on securities sold (based on average book value), reduced by profits realized to the extent that such profits exceeded the amount of capital surplus, if any, applied December 16, 1930, in reduction of book value of securities sold. Capital surplus account reflected the profits on sale of securities based on book value, not exceeding the amount of capital surplus applied December 16, 1930, in reduction of book value of such securities. In 1933, undistributed income account reflected net losses of $525,721 realized on sale of securities prior to April 30, 1933, computed on the basis of book values as adjusted December 16, 1930. The balance sheet reflected net profits of $185,068 realized on sale of securities subsequent to April 30, 1933, computed on the basis of book values as adjusted April 29, 1933, as "Undistributed Profits from sale of Securities (Net)," which was a subdivision of "Earned Surplus and Undistributed Profits (subsequent to April 30, 1933)."

[d] American International Corporation—This corporation created a reserve in October 1924, for the excess of the book value of securities owned then over the market value as of that date. This reserve, which was increased and decreased by certain trading profits and losses, remained on the books to the end of 1930. During 1927 to 1930, trading results were carried in part to Income account and in part to this Reserve account. In 1927, 1928 and 1929, the results carried to Income account only were disclosed in the published reports. In 1930 the results carried to each of these accounts were revealed in the statements of the respective accounts. See discussion of this matter in review of portfolio reserves, p. 2335

[e] Central States Electric Corporation—As to 1931, the net profits carried to Surplus account aggregated $747,776. However, an appropriation of $85,239,563 was made from Investment Reserve in reduction of the book value of The Goldman Sachs Trading Corporation Capital Stock, applied to portion thereof sold during year, and in consequence neither profit nor loss was recorded with respect to this sale. The said investment reserve was an amount allocated from Capital Surplus after reduction of Capital Stock account in February 1931 of $11,897,373.50.

As to 1933, the trading results comprising net losses of $2,514,837 were, after application of write-downs in Investment Reserve (1) of $3,885,725.04 on Shenandoah Corporation common stock and (2) of $2,772,085.46 on The Goldman Sachs Trading Corporation Capital Stock. These 1933 charges to Investment Reserve totaled $6,657,810.50, which, together with the 1931 Investment Reserve charge of $5,239,563, aggregated $11,897,373.50, which was the amount of the reduction of common Capital Stock account by the company in February 1931.

[f] Old Colony Investment Trust—The Reserve was created from realized profits, after taxes, from organization to February 1, of previous year, and from Discounts on Debentures repurchased and retired.

[g] Phoenix Securities Corporation—Amounts realized on certain assets which were written down to a nominal value of $1.00 each were reflected in the Surplus account.

[h] Reynolds Investing Co., Inc.—The published Earned Surplus account of December 31, 1935, included the following items:

"Net loss for period January 1 to September 30, 1935 (including $60,342 net loss from sales of securities computed on original cost basis)	$89, 537
Net income for period from October 1 to December 31, 1935 (including $66,139 net profit from sales of securities on cost basis of adjusted book values as of September 30, 1935)	84, 497"

The difference between the above net profit of $66,139 and the above net loss of $60,342 is $5,797, which was described as "Net Profit on Securities Sold and Written Off," and shown as an addition to income in the published Income account. The final result for the year 1935 in published Income account was a net loss of $5,040, which is the same as the difference between $89,537 and $84,497, shown above.

SCHEDULE 2.—*Treatment of profits and losses upon sales of securities by open-end investment trusts and companies as indicated in published reports or in replies to Commission's questionnaire*

[Classifications under which results were shown in years indicated. An asterisk indicates net losses were realized for the year shown]

Name of company	1927, 1928 and 1929	1930	1931	1932	1933	1934	1935
Bullock Fund, Ltd. (established in 1932).					Earned Surplus	Earned Surplus*	Earned Surplus.
Canadian Investment Fund, Ltd. (established in 1932).					Capital Surplus	Special Account, Realized profit on sale of securities.	Special Account, Realized profit on sale of securities.
Dividend Shares, Inc. (established in 1932).				Capital Surplus*	Earned Surplus	Earned Surplus	Earned Surplus.
Group Securities, Inc. (established in 1933).						Special Account under Earned Surplus.*	Special Account under Earned Surplus.
Incorporated Investors.	1927 to 1929: Item not shown (In Questionnaire, in Surplus).	Item not shown (In Questionnaire, in Surplus).*	Item not shown (In Questionnaire, in Surplus).	Item not shown (In Questionnaire, in Surplus).*	Paid-in Surplus*	Paid-in Surplus*	Paid-in Surplus.
Investment Trust Fund A.	1927 to 1929: Income	Loss and Distributions (In Questionnaire, in Income).*	Item not shown (In Questionnaire, in Income).*	Item not shown (In Questionnaire, in Income).*	Item not shown (In Questionnaire, in Income).*	Profit and Loss (in letter)* (In Questionnaire, in Income).	Profit and Loss (in letter) (In Questionnaire, in Income).
Investment Trust Fund B.	1927 to 1929: Income	Income	Undistributed Accumulations* (In Questionnaire, in Income).	Item not shown (In Questionnaire, in Income).*	Item not shown (In Questionnaire, in Income).*	Item not shown (In Questionnaire, in Income).*	Profit (in letter) (In questionnaire, in Income).
Investors Fund C, Inc. (established in 1930).			Special account under Capital Surplus.*	Special account under Capital Surplus.*	Special account under Earned Surplus.	Addition to net ordinary Income.	Addition to net ordinary Income.
Maryland Fund, Inc., The (established in 1934).						Special account under Earned Surplus.	Special account under Earned Surplus.

Massachusetts Investors Trust.	1927 to 1929: Special account under Surplus.	Special account under Surplus.*	Statement of Receipts and Charges on Principal account.*	Statement of Receipts and Charges on Principal account.*	Statement of Principal.*	Statement of Principal.*	Statement of Principal.
Nation-Wide Securities Co. (established in 1932).	----------	----------	----------	Special account under Surplus.	Earned Surplus	Earned Surplus	Earned Surplus.
Quarterly Income Shares, Inc. (established in 1932).	----------	----------	----------	----------	Unappropriated Net Profit from Sales of Securities.	Unappropriated Net Profit from Sales of Securities.	Unappropriated Net Profit from Sales of Securities.
Spencer Trask Fund, Inc.	1929: Income	do	Special account under Surplus.*	Special account to Mar. 31, 1932; balance then existing (net losses) transferred to Capital Surplus.*	Capital Surplus*	Capital Surplus*	Capital Surplus.*
State Street Investment Corporation.	1927 to 1929: Income	Income*	Income*	Losses upon securities held Dec. 31, 1931, to Reserve (allocated Surplus); other results which were profits, to Surplus. See discussion in Sec. B, 5.	Losses upon securities held Dec. 31, 1931, to Reserve (allocated Surplus); other results which were profits, to Surplus. See comments in Reserve Section.	Surplus (In Questionnaire, in Earned Surplus).	Surplus (In Questionnaire, in Earned Surplus).

APPENDIX L

SCHEDULE 1.—*Write-downs of investments by 17 closed-end management investment companies, 1927–1935*

Name of company	Write-Down		Balance of earned surplus at date of write-down	Accounts to which write-downs were charged			
						Other Accounts	
	Year	Amount		Earned surplus	Capital surplus	Name	Amount
American Cities Power and Light Corporation	1930	$20, 585, 669	$8, 177, 270	$3, 788, 177	$16, 797, 492		
	1933	13, 581, 008	524, 893	524, 893	13, 056, 115		
American International Corporation	1933	17, 614, 438	358, 195	358, 195	17, 256, 243		
Blue Ridge Corporation	1932	87, 773, 497	3, 312, 739	3, 312, 739	60, 213, 280	Reserve (allocated cap. surplus)	$24, 247, 478
Electric Shareholdings Corporation	1929	6, 974, 242	4, 466, 538	1, 916, 203	5, 058, 039		
	1930	11, 746, 314	2, 623, 149		11, 746, 314		
	1931	12, 625, 155	990, 000	990, 000	11, 635, 155		
General Public Service Corporation	1931	12, 414, 826	4, 072, 313	4, 072, 313	8, 342, 513		
Home and Foreign Securities Corp	1934	1, 329, 565	([a])		1, 329, 565		
Investors Equity Company, Inc	1931	10, 818, 501	2, 979, 241		10, 818, 501		
M. & T. Securities Corporation	1932	10, 666, 257	1, 141, 844		3, 269, 312	Reserve (allocated cap. surplus)	4, 474, 945
						Capital stock	2, 922, 000
	1933	508, 580	233, 889	233, 889	246, 983	Reserved (allocated cap. surplus)	27, 708
Oils & Industries, Inc	1931	3, 492, 187	92, 013	92, 013	3, 400, 174		
Old Colony Trust Associates	1933	9, 272, 400	[b] 413, 737			Balance arising from restatement of capital shares.	9, 272, 400
	1934	2, 079, 789	30, 047			do	2, 079, 789
	1935	[c] 769, 667				do	[d] 769, 667
Petroleum Corporation of America	1930	55, 372, 658	4, 268, 242		55, 372, 658		
Railway and Light Securities Company	1932	8, 610, 348	2, 278, 888	2, 278, 888		Common stock (revaluation)	6, 331, 460
Reybarn Company, Inc., The	1931	9, 314, 596	680, 934		9, 314, 596		
Reynolds Investing Company, Inc	1935	7, 121, 988	494, 863	494, 863	6, 627, 125		
Selected Industries, Incorporated	1931	18, 377, 086	2, 413, 702			Combined surplus	18, 377, 086
Utility Equities Corporation	1931	12, 793, 101	2, 260, 542	2, 260, 542	10, 532, 559		
Utility and Industrial Corporation	1935	1, 904, 181	2, 900, 412		1, 904, 181		

[a] Deficit charged to capital surplus at time of write-down.
[b] Earned surplus balance transferred to reserves for dividends and other purposes.
[c] Write-up to book and quoted values.
[d] Credited to balance arising from restatement of capital shares.

SCHEDULE 2.—*Write-downs of investments by 17 closed-end management investment companies, 1927–1935. Treatment of profits and losses on sales of investments after write-downs, reductions in stated capital, and payment of cash dividends after write-downs and reductions*

Name of company	Year	Where investment profits or losses after write-downs shown in reports [a]					Reductions in stated capital		Cash dividends paid after write-down	
		Included in income	Addition to or deduction from net ordinary income	In earned surplus	Other accounts					
					Name	Amount	Year	Amount	Year	Amount
American Cities Power and Light Corporation [b]	1930	$788,456					1930	$19,006,650	1930	$512,253
	1931			($649,043)	Capital surplus	$688,862	1931	11,632,321	1931	762,936
	1932			(1,543,963)			1932	4,118,425	1932	611,842
	1933			185,068					1933	920,105
				(525,721)						
	1934			98,764					1934	752,848
	1935			784,144					1935	462,651
American International Corporation	1933			842,139			1933	14,778,204	None	
	1934			825,629						
	1935			1,077,666						
									1931	2,626,421
									1932	2,227,518
Blue Ridge Corporation	1933			2,351,084			1930	29,953,921	1933	2,044,256
	1934			1,939,226			1932	20,155.050	1934	2,032,465
	1935			3,559,331					1935	1,739.538
Electric Shareholdings Corporation	1930	[c] 650,005					1930	11,874,002	1931	1,078,449
	1931				Consolidated surplus [d]	(289,570)	1931	6,416,749	1932	487,702
	1932				" "	(709,330)			1933	451,803
	1933				" "	(364,533)			1935	304,485
	1934				" "	(768,221)				
	1935				" "	38,558				

See footnotes at end of table.

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SCHEDULE 2.—*Write-downs of investments by 17 closed-end management investment companies, 1927–1935. Treatment of profits and losses on sales of investments after write-downs, reductions in stated capital, and payment of cash dividends after write-downs and reductions*—Con.

Name of company	Year	Where investment profits or losses after write-downs shown in reports: Included in income	Addition to or deduction from net ordinary income	In earned surplus	Other accounts: Name	Other accounts: Amount	Reductions in stated capital: Year	Reductions in stated capital: Amount	Cash dividends paid after write-down: Year	Cash dividends paid after write-down: Amount
General Public Service Corporation	1932			($530, 292)			1931	$8, 392, 952	None	
	1933			118, 821						
	1934			(36, 827)						
	1935			420, 608						
Home and Foreign Securities Corp	1934	$20, 894					1933	1, 846, 887	None	
	1935			1, 344						
Investors Equity Co., Inc	1932				Profit and loss reserve (alloc. earned surplus).	$3, 830, 255	1931	11, 727, 591	None	
M. & T. Securities Corporation	1932	[c] (31, 448)					1931	3, 652, 500	1931	$474, 825
	1933	[c] (231, 921)					1932	2, 922, 000	1932	36, 525
	1934	[c] 573							1935	14, 610
	1935	[c] 456, 853								
Oils & Industries, Inc	1931	[c] 4, 029					1931	3, 284, 814	1934	32, 441
	1932		($184, 383)				1933	1, 615, 815	1935	37, 233
	1933		(121, 923)							
	1934		115, 490							
	1935		130, 554							
Old Colony Trust Associates	1934	[c] 319					1932	295, 813	1933	225, 724
	1935	[c] 200					1933	13, 936, 452	1934	225, 724
									1935	225, 724
Petroleum Corporation of America	1931				Profit and loss on realization of investments.	(1, 863)	1930	32, 827, 200	1931	1, 348, 175
	1932				"	(66, 153)			1934	1, 067, 230
	1933				"	1, 129, 572			1935	695, 370
Petroleum Corporation of America	1934				Profit and loss on realization of investments.	627, 043				

	1935				do	630, 312				
Railway and Light Securities Co	1932				Special surplus [f]	(140, 416)	1932	6, 331, 460	1932	187, 462
	1933				do	37, 535			1933	126, 378
	1934				do	72, 202			1934	126, 513
	1935				do	310, 455			1935	126, 541
Reybarn Company, Inc., The	1932				Reserve for securities (alloc. capital surplus)	(219, 376)	1931	11, 905, 875	None	
	1933				do	(238, 342)				
	1934				do	337, 733				
	1935				do	(23, 915)				
Reynolds Investing Co., Inc. [g]	1935						1933	5, 526, 069	None	
Selected Industries, Incorporated	1932				Combined surplus	[c] (3, 778, 080)	1931	29, 699, 848	1931	3, 388, 394
	1933				do	[c] (3, 068, 718)	1932	13, 788, 600	1932	2, 212, 352
	1934				do	[c] (1, 519, 949)			1933	2, 211, 939
	1935				do	[c] 371, 567			1934	2, 010, 871
									1935	1, 774, 911
Utility Equities Corporation	1932		107, 924				1931	12, 085, 845	1932	569, 778
	1933		(515, 985)						1933	349, 168
	1934		255, 606						1934	339, 675
	1935			56, 649					1935	330, 190
Utility and Industrial Corporation	1935				Capital surplus	[c] (8, 797, 880)	1932	22, 444, 288	None	

[a] Figures in parentheses denote losses.

[b] In 1931, operating surplus account reflected the losses on securities sold (based on average book value), reduced by profits realized to the extent that such profits exceeded the amount of capital surplus if any applied December 16, 1930 as reduction of book value of securities sold. As a restoration to capital surplus, capital surplus account reflected profits on sales of securities (based on book value) not exceeding the amount of capital surplus applied December 16, 1930, in reduction of book value of such securities. In 1933 undistributed income account reflected net losses of $525,721 realized on sale of securities prior to April 30, 1933, computed on the basis of book values as adjusted December 16, 1930. The balance sheet reflected net profits of $185,068 realized on sale of securities subsequent to April 30, 1933, computed on the basis of book values as adjusted April 30, 1933, as "undistributed profits from sales of securities (net)" as a subdivision of "earned surplus and undivided profits" subsequent to April 30, 1933.

[c] Basis for reporting profits and losses on sales of securities not indicated in report.

[d] In the reply to Commission's questionnaire, losses shown in operating surplus and gains n capital surplus.

[e] Not shown separately in report.

[f] Report for year ended December 31, 1932, stated: "Special surplus—As a result of the revaluation of securities as at February 10, 1932, and the reduction of capital, it will probably be necessary to retain as surplus or credit to capital any profit from security sales arising out of assets owned on February 10, 1932, until the amount of the reduction in capital represented by common stock has been made up. A special surplus account has been set up to segregate from other profits the profits arising from such security sales."

[g] This company established a new earned surplus account from October 1, 1935, to which were carried operating and trading results for the last quarter of the year including net profits of $66,138 from the sale of securities computed on the basis of the adjusted book values at September 30, 1935. The net realized losses for the first three quarters upon original cost basis was $60,342. In the published report for the year 1935, only the net result, a profit of $5,796 was disclosed, shown under income with an explanation but without revealing that the trading result to September 30, based on original cost values, was a loss, and from October 1, based on adjusted book values, a profit.

Appendix M

RECOMMENDATIONS BY REPRESENTATIVES OF INVESTMENT TRUSTS AND INVESTMENT COMPANIES WITH RESPECT TO ACCOUNTING PRACTICES AND REPORTS TO STOCKHOLDERS

The managements of a number of investment companies made specific recommendations as to the form and content of financial statements during the course of the public examinations or in statements submitted to the Commission. Several of these views are presented.

By Robert Lehman, president of The Lehman Corporation: [1]

I would suggest that investment trusts should issue quarterly reports to their stockholders which should also be filed with the Securities and Exchange Commission and any Stock Exchange concerned. These reports should furnish full public information on the operations of the investment trust, including such things as direct transactions, underwriting activities, and brokerage commissions. They should be based upon standard accounting principles, to be developed through a committee of representatives of the Securities and Exchange Commission and the investment trusts. Specifically, these reports would include the following items, in addition to those now customarily included:

(1) List all sales to and purchases from sponsors, officers and directors, stating date of transaction, amount and title of security, and prices.

(2) List joint purchases or sales, stating names of participants and interest of each. (Details of transactions under (1) and (2) to be available to stockholder on call at principal office. Net asset value to be available at any time upon inquiry from stockholder.)

(3) In the event of repurchase of own securities, or those of a subsidiary or affiliate, show amount and cost, and source.

(4) Gross Brokerage—percent of assets, to whom paid.

(5) Brokerage paid, not at regular exchange rates, to whom paid.

(6) Brokerage received by director, officer or sponsor on sale to the trust.

(7) Reveal underwriting obligations specifically.

Report results of any underwritings.

(8) Report cost basis and market or valuation basis of each classification of the portfolio.

(9) Report any underwriting or public issue of securities by the sponsor of a company, any of whose securities were held by the investment trust within six months prior to such underwriting or public issue.

(10) Designate any items in the portfolio so as to show whether representatives of the sponsors or of the investment trusts are represented on the Board of Directors of any company whose security is in the portfolio, and in addition, whether the sponsor has participated in a public offering of the security.

(11) Report in detail any special kind of income or loss amounting to 5 percent of net profit or net loss for the quarter.

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[1] Public Examination, The Lehman Corporation, at 5653–6.

(12) Report percent of total net asset value represented by government bonds and securities listed on New York Stock Exchange and New York Curb Exchange.

I am convinced that if the Securities and Exchange Commission should so desire, the investment trust industry would cooperate fully with the Commission in developing workable regulations and plans for reports, and, with the aid of a committee of experienced accountants would cooperate in developing standard accounting principles for application to investment trusts.

By Earle Bailie, chairman of the board, Tri-Continental Corporation:[2]

In addition to these specific prohibitions, which would go effectively to the root of the majority of both the revealed and alleged abuses, proper regulatory legislation should require:

(1) Full disclosure of all relevant facts to shareholders at quarterly intervals in formal reports, including—

(a) Proper and complete financial statements.

(b) Full information as to underwritings and syndicate participations.

(c) Information of brokerage and other commissions paid and to whom.

(d) Information as to all transactions in which officers, directors, sponsors, and ten-percent shareholders have any interest.

(e) Information as to any large or unusual transactions, and possibly lists of all securities bought or sold.

(f) Names of directors and officers and their principal affiliations.

(2) Uniform accounting in accordance with broad rules to be promulgated by the Commission.

(3) All reports to be certified and security holdings verified by independent auditors, elected by the shareholders at annual meetings and responsible to them.

(4) Disclosure of all pertinent information in connection with charter amendments, management contracts, mergers, acquisitions and reorganizations when submitted for approval of shareholders.

It seems to me that both the investing public and investment company management would benefit from some method of providing assurance to the public and the shareholders that the provisions of any regulations are being adhered to scrupulously and carefully. As a possible means of providing such assurance, I venture to suggest periodic verification of security holdings and review of transactions by a bureau of examination and audit to be set up by the Securities and Exchange Commission for that purpose. The function of the bureau would be similar to that of the national bank examiners in that it would verify security holdings and review the transactions of an investment company at periodic intervals. Any report of criticism, based on such examinations, would be sent to the directors of the company for their attention and action, and the failure of directors to take appropriate action within a reasonable time should permit the bureau to put its findings before the shareholders themselves.

By Leland Rex Robinson, formerly president, Second International Securities Corporation, United States & British International Company, Ltd., and American & General Securities Corporation:[3]

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[2] Public Examination, Tri-Continental Corporation, Commission's Exhibit No. 2094.

[3] Public Examination, American General Corporation, et al., Commission's Exhibit No. X4338.

Among the data to be clearly set forth in reports, which should be at least semiannual, are the following:

A. If the investment or underwriting profits and losses in any way enter into the income statement, either directly or in textual résumés of per-share earnings, distinction should be made between capital profits and other, normally recurrent, sources of income. Wherever capital profits are described as income it should be made concurrently clear what changes have occurred over the period in question in the unrealized appreciation or depreciation of securities at market as compared with cost, in order that a global picture of performance may be given. If total per-share earnings are given *inclusive* of capital profits, total per-share earnings should also be given *exclusive* of such profits. If the income account regularly includes capital profits, it should as regularly include capital.

B. When the investment company has other than a simple capital structure consisting of common shares only, the upward and downward effect of leverage should be brought out clearly in the reports. Thus, on the basis of the existing capital structure at the time of the report attention should be called to the effects upon asset values and earnings for the different classes of securities outstanding of upward and downward movements of certain percentages such as 10, 20, 30% in value of assets and in gross income. If the company is permitted by its debenture indenture, its charter, or its by-laws, to incur additional debt or to issue additional senior securities of any type, the potential leverage involved should be set forth. Otherwise an entirely erroneous impression may be conveyed of the expectations of the common shareholder as regards earnings and asset values in the event that there is any substantial increase or decrease in gross earnings or in market values of assets.

C. The cost of raising capital should be clearly set forth and the accounting methods followed in charging off this cost, or in currently writing it down. Debenture discounts should be charged off against income, in order that debt service charges may faithfully reflect cost of borrowed capital.

D. There should be a classification of investments geographically, by type of issuer, and by type of security. Where the investment company possesses more than, let us say, 5 or 10% of any issue of stock of another company, or where it and affiliated companies possess as much as 20% or more of the controlling stock in any other company, this should be pointed out in any classification of investments.

E. There should be prescribed a standard break-down of expenses in reports, and ratios should be given of total expenses in terms of aggregate asset values and earnings.

F. Where dividends have been paid other than from current interest and dividend income, the sources of these dividend payments by the investment company should be given. Stock dividends should have their sources clearly revealed. In other words, exactly how are they charged and against what?

G. The managerial compensation should be set forth clearly and comprehensively.

H. There should be standard requirements for the definition of "capital surplus" and "earned surplus" in order that it may be evident what distinctions there are between them and how the "capital surplus" of any company originated.

I. Any capital changes and retirements over the period in question should be set forth, with reasons therefor and effects thereof on earnings and asset values.

By Henry M. Minton, vice president and chief executive officer, Spencer Trask Fund, Inc.: [4]

On the question of uniform accounting, we have the following to suggest:

We believe that it would be well to require reports on prescribed forms, the standard varied for different types of trusts. In addition to the customary portfolio statement and balance sheet, I suggest that the following material be included in quarterly reports:

1. The number of shares of stock and par value of bonds purchased and sold, profit and loss thereon, and brokerage commissions paid, the names of brokers, if directly or indirectly associated with the management or selling agent.
2. Bonds or stocks acquired from management firm as principal, with statement of profit to management firm from such transaction.
3. Syndicate participations with profits or loss thereon.
4. Break-up of portfolio to disclose cost and market value of various items.

By Charles F. Glore, investment banker, former director of The Chicago Corporation: [5]

1. Accounting and Reports. I believe that financial statements and accounting practices should be standardized; that the Securities and Exchange Commission should establish and prescribe insofar as is possible definite principles and forms to be followed; that investment corporations should be required to file reports which should show reasonable detail as to costs, brokerage commission, fees and charges, direct transactions with the sponsors or others connected with the management, underwriting activities, and so forth, in short, I believe that a proper disclosure of condition and material transactions through regular reports is the most practical protection to investors.

I believe that these reports should be semi-annual and that they should be audited by independent certified public accountants. Beyond this, I do not believe the additional cost of more frequent reports, or periodic unannounced examinations by an examining authority similar to bank examinations is justified.

[4] Public Examination, Spencer Trask Fund, Inc., at 3204–5.

[5] Public Examination, The Chicago Corporation, at 9834–5.

Appendix N

THE EQUITY CORPORATION COMBINED STATEMENT OF ASSETS AND LIABILITIES [1]

In order to determine whether to accept an exchange offer, stockholders should have a clear understanding of the relative values of the two securities involved. Consequently, it is imperative that balance sheets and other financial statements contain complete, accurate and informative data concerning the financial condition and operation of the offeror corporation. But some of the balance sheets and other statements of financial condition, which Equity issued in connection with the exchange offers, were both incomplete and misleading.

As we have indicated, The Equity Corporation from the outset contemplated a program of expansion, involving as its basis the acquisition of control of other companies by exchanges of stock. The financial statements were prepared with the exchange program in mind. It is in relation to this program that the statements of financial condition of The Equity Corporation must be considered.

As we have heretofore stated, upon its incorporation on December 7, 1932, The Equity Corporation acquired control of Allied General Corporation and Yosemite Holding Corporation from Messrs. Groves and Donaldson. The latter company controlled Chain & General Equities, Inc., which in turn controlled Interstate Equities Corporation. The Equity Corporation's holdings of Allied General stock had an asset value of approximately $250,000. Its holdings in Yosemite Holding Corporation stock had no asset value. The Equity Corporation had no other assets at the time except $50,000 in cash. Therefore, in December 1932, the asset value of securities owned by Equity together with its cash aggregated about $300,000. As we have also shown, however, these holdings brought assets of approximately $6,500,000 under Equity's control.

In the spring of 1933, exchange offers were made to the stockholders of Yosemite Holding Corporation, Allied General, and Chain & General. Balance sheets dated respectively December 31, 1932, February 28, 1933, and March 31, 1933, were included in the circulars sent these stockholders at different times in connection with the offers. The December and March statements were certified by Price, Waterhouse & Co.; the February statement by W. Franklyn Best, treasurer of The Equity Corporation. These three balance sheets, which were similar in form, were entitled "Combined Statement of Assets and Liabilities" and bore the parenthetical notations, "Giving effect as at that date to the completion of the present exchange program which contemplates the eventual exchange of *all* of the stocks of Allied General Corpora-

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[1] Excerpt from the Commission's report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees, Part VII, pp. 253–262.

tion and Chain & General Equities, Inc., and *all* of the stocks and warrants of Yosemite Holding Corporation by the holders thereof for the stocks of The Equity Corporation." That is to say, although these balance sheets were not entitled "*pro forma*", they carried an indication that this was their effect.

The propriety of using such a balance sheet in a situation of this character, even if it had been expressly entitled a *pro forma* balance sheet, is open to serious question. A *pro forma* balance sheet should be used only where the contingencies upon which it is based are reasonably certain to occur within a reasonably short period of time. It is evident that otherwise such a balance sheet is likely to create a definitely misleading picture. This is even more clearly the case where the contingencies upon which the balance sheet are based cannot occur. In fact, Rodney F. Starkey, a partner of Price, Waterhouse & Co., indicated in testimony before this Commission that he would refuse to sanction a "*pro forma* combined balance sheet" if he knew that the contingencies on which it was based were certain not to occur.

Yet this was essentially the Equity situation. It will be noted that the principal assumption made in setting up this balance sheet was the exchange of *all* the securities affected. Mr. Starkey testified, however, that he never expected the exchange program to be 100 percent successful:

Q. * * * of course, even if you call the "combined balance sheet" pro forma, based upon an exchange offer, you would not want to see a balance sheet go out under those conditions where you knew it was a positive certainty that those conditions could not occur?

A. I think the obvious answer to that is "no."

Q. That is right. This balance sheet, combined balance sheet, is predicated * * * in the first place, * * * on the fact that the offer would be accepted 100 percent by every single stockholder of Yosemite, Chain and General. Isn't that so?

A. Not every stockholder, no. Enough to insure the merger of those companies. They had to buy out some of these stockholders finally.

* * * * * * *

A. No exchange is ever 100 percent, that I know of.

Q. This gives the date of the exchange program which contemplates the eventual exchange of all the stock of Allied General Corporation, Yosemite, etc., so that this was predicated on the fact that everybody would accept the exchange offer.

A. Of course.

Q. And you knew that was an impossibility?

A. I would know that every time I showed the exchange of one kind of bond for another. That is impossible. You can't have 100 percent.

Mr. Best was similarly aware of the unlikelihood of complete success:

Q. Well, Mr. Best, you were not fooling yourself. You knew that you could never effectuate a 100 percent exchange, isn't that so?

A. Very improbably.

Q. So that that combined balance sheet which Price, Waterhouse signed, which was based on the fact that the exchange offer would be effected 100 percent, was based first on the probability that you could not get 100 percent? Isn't that so?

A. Well, I think it is improbable that you could ever get 100 percent.

As appears from his testimony quoted above, Mr. Starkey made the point, inferentially, that the March 31st statement was adequate because it portrayed the condition of the Equity group as it would look after the absorption of all the assets of its subsidiaries. Although admitting the impossibility of making the exchange offers completely effective ,Mr. Starkey's implication was that that portion of the subsidiaries' assets not obtained through exchanges would be absorbed through merger.

There are several points to be made with reference to such an explanation, however. In the first place, in any merger a certain number of dissenting security holders would claim payment and appraisal for their shares, with some resultant decrease in the assets of the company. In the second place, as we shall see, two of these companies, Yosemite and Allied General, were dissolved rather than merged, and a portion of their assets were paid out to those who did not accept the exchange offers. Finally, the fact remains that these balance sheets were predicated on the assumptions both that the exchange program would be completed within a reasonable time and that it would be accomplished on the basis of the ratios first proposed. In other words, it assumed completion of the exchange program within such period of time that any material change in the value of the assets or the amount of the liabilities of the companies would be unlikely. And it further assumed that the additional stock issued by Equity would be the amount contemplated by the existing offer. In fact, the exchange offers were not terminated for approximately two years, and during that time the ratios of exchange were repeatedly changed. Thus, Mr. Starkey testified:

Q. This was also predicated on the fact that this exchange offer would take place within a reasonable time after it was made?

A. Yes.

Q. Do you know how long it took The Equlty Corporation to complete its exchange program?

A. Do you? I would like an exact time.

Mr. Pryor: The Chain & General and Interstate were merged on March 25, 1935.

Q. That is two years after this statement, isn't that so?

Mr. Pryor: Approximately.

* * * * * * *

Q. You also had a pretty good idea that during the course of the program you might have to change the exchange offer.

A. They were doing that regularly.

Q. Yet at the time you made this balance sheet and gave this picture to the person as to what the company was going to look like, you knew there was the possibility they would have to change the rate of exchange.

A. That is true.

Q. And the fact is that they did change [the offer].

A. That is true.

Realistically there was no sound basis for the assumptions upon which these balance sheets were based. In other words, since the ultimate scope of the exchange program and the details of its execution differed materially from those assumed in the preparation of this balance sheet such statement would not reflect even approximately

the condition of Equity at the conclusion of the exchange program. And Mr. Best testified:

Q. But what it does not show is what a stockholder of one of the underlying companies was getting when he got Equity stock at that time. Isn't that so?

A. He didn't know what he was getting.

The use of the title, "Combined Statement of Assets and Liabilities" for these balance sheets should be noted. It appears that Price, Waterhouse & Co. would not certify a *consolidated* balance sheet for Equity and its controlled companies. In April 1933—apparently shortly after the issuance of the March 31, 1933, "Combined Statement" that we have described—The Equity Corporation submitted a consolidated balance sheet to Price, Waterhouse for examination. In a letter dated April 11, 1933, Price, Waterhouse replied as follows:

Mr. W. Franklyn Best,
Treasurer, The Equity Corporation,
63 Wall Street, New York, N. Y.

Dear Sir: In accordance with your request, we have examined the attached consolidated balance sheet of The Equity Corporation and Yosemite Holding Corporation, Chain & General Equities, Inc., Allied General Corporation, Interstate Equities Corporation, as at March 31, 1933, which has been prepared by you. *The assets shown on the attached balance sheet correspond in description and amount with those shown on the combined statement of assets and liabilities at March 31, 1933, of the above-mentioned companies, upon which we reported under date of April 1, 1933.*[2] The accounts payable shown on the attached balance sheet are stated at $49,741.46 less than the corresponding item on the combined statement of assets and liabilities mentioned above, the difference representing the estimated amount of commissions and expenses incident to the completion of the exchange program summarized in Schedule B attached.

We have checked the arithmetical accuracy of the amount of net assets of companies included herein applicable to capital stocks held by outsiders, and also the amount of capital surplus, representing The Equity Corporation's proportion of net assets at March 31, 1933, in excess of the par value of the capital stock outstanding at that date. As at March 31, 1933 the capital stocks held by outsiders of the four companies mentioned below whose assets have been included in the attached balance sheet, expressed in percentages, may be summarized as follows:

	Percent of total stocks outstanding in hands of outsiders (approximate)
Yosemite Holding Corporation:	
Preferred stock	83
Common stock	39
Common stock purchase warrants	92
Chain & General Equities, Inc.:	
Preferred stock	68
Common stock	39
Allied General Corporation:	
Preferred stock	33
Class A stock	30
Common stock	28
Interstate Equities Corporation:	
Preferred stock	95
Common stock	42

[2] Italics supplied.

In view of the large proportion of the outstanding capital stock held by outsiders, we are of the opinion that the preparation of a consolidated balance sheet of The Equity Corporation and the above four companies is not in accordance with good accounting practice.[2]

And Mr. Starkey testified:

Q. One of the difficulties with a consolidated balance sheet is that it may create a misleading impression, in this respect: that you may get a picture of the assets of the corporation which is not genuine or true because there may be a substantial minority interest which owns a substantial interest in the Company; is that not so?

A. That is very possible.

It would seem that the objections of Price, Waterhouse to a consolidated balance sheet for this group of companies were equally applicable to the earlier combined statements of assets and liabilities. In substance and content there was no difference between the two. As the letter to the company of April 11th indicates, the two statements would show the same assets and the same liabilities. No more specific or accurate information would be presented the security holders by the "combined statement." Mr. Starkey testified, however, that they "preferred not to" sign a consolidated balance sheet, because the term "consolidation" has a sort of special significance, and we felt that this [i. e., the "combined" statement] was the better way of expressing it.

It is difficult to perceive what additional enlightenment a stockholder would obtain from the use of the title "Combined Statement of Assets and Liabilities." In fact, Mr. Starkey admitted that he did not know what meaning the phrase "combined balance sheet" might convey to the investor. He testified:

Q. Now, you said that you would not sign a consolidated balance sheet under the circumstances which I enumerated to you, because the words "consolidated balance sheet" had definite connotations in the minds of the public; is that not so?

A. I do not recall exactly how I said it, but that sounds like a reasonable statement.

Q. Are you familiar with what connotations or inferences are present in the investor's mind when he sees the words "combined balance sheet?"

A. I do not know.

In any event, shortly thereafter, despite the position taken by its auditors, Equity issued a consolidated balance sheet, dated as of May 31, 1933. It was certified by W. Franklyn Best, treasurer of the company, not by Price, Waterhouse & Co. Mr. Best testified:

Q. Approximately six weeks after you got that letter you signed a consolidated balance sheet for The Equity Corporation, did you not?

A. Yes.

Q. Did you just not pay any attention to the letter you got from Price, Waterhouse, saying that it violated good accounting practice to issue a consolidated balance sheet?

A. I presume we did. I issued this statement.

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[2] Italics supplied.

Q. Did good accounting practice mean the same thing to you that it meant to the chief auditing firm for The Equity Corporation?

A. Well, it may or may not. I thought this was an informative statement.

Q. * * * in any event you deliberately issued a combined [sic: "consolidated"] statement as of May 31, 1933, after you had received a communication from your auditing firm * * * that it would not be good practice, isn't that so?

A. That is true.

No testimony was offered in extenuation of the fact that Equity issued a consolidated balance sheet despite the opinion of its auditors that in view of the large proportion of the outstanding capital stock held by outsiders, preparation of a consolidated balance sheet would not be in accordance with good accounting practice.

Appendix O

ATLAS CORPORATION—USE OF "COMBINED" FINANCIAL STATEMENTS [1]

As has been indicated, the intention of the acquiring corporations was to acquire, if possible, by the ultimate processes of dissolution, merger, or consolidation, the entire ownership of the assets of their controlled investment companies by means of future offers to exchange the acquiring corporations' own securities for the public's holdings of the securities of their controlled investment companies or by the purchase of such securities.

This purpose added greater importance to the character of the financial statements which the acquiring corporations released to the public. Their financial statements would presumably be consulted by investors with reference to their exchange offers. Such financial statements, in order to be complete, would have to indicate clearly the extent of the minority interests in the controlled investment companies as well as the asset value of the common stock of the acquiring corporations. Nevertheless, the financial statements released by the acquiring corporations did not indicate clearly either of these facts.

By December 31, 1931, Atlas Corporation was in control of 10 investment companies other than Atlas Utilities & Investors Co., Ltd., its Canadian predecessor. In several cases its control was based on the ownership of the common stock of leverage companies. Such common stock in each case had no asset value. In other words, the preferred stockholders of such companies would have been entitled to receive all of the assets of such companies in the event of their dissolution. Atlas Corporation, at the end of 1931, held only a minority interest in the preferred stocks of the leverage investment companies which it controlled. In one case, that of Federated Capital Corporation, Atlas Corporation held a minority of the voting stock of all classes, its control having been maintained by means of a management contract. And in another case, that of Securities Allied Corporation, Atlas Corporation controlled all of the 100,000 shares of voting common stock but only 36% of the nonvoting common stock which was, on dissolution, entitled to an equal participation in the corporate assets with the voting stock. Schedule 5 indicates the security holdings as of December 31, 1931, both of Atlas Corporation (and its subsidiaries) and of the public in the securities of the Atlas Corporation controlled companies.

The public "owned" approximately $37,385,000 of the assets of Atlas Corporation's controlled investment companies. Since the net

[1] Excerpt from Ch. IV of this part of the report, pp. 1400–9.

assets of Atlas Corporation and these controlled companies after the elimination of all intercompany holdings, at December 31, 1931, approximated $53,700,000, it is obvious that the assets of Atlas Corporation, including its interest in these companies, were only approximately 30% of the net assets of the entire group of companies; the bulk of the assets in the group was "owned" by the public holders of the securities of the subsidiary corporations.

The first financial statement issued by Atlas Corporation as of December 31, 1931, was released on February 29, 1932, captioned "Combined Statement of Financial Condition." This "combined statement" was certified by Lybrand, Ross Bros. & Montgomery, certified public accountants, as setting forth "the combined financial condition of the said companies." The "combined statement" indicated the assets of Atlas Corporation and its subsidiaries in much the same manner as would a consolidated statement. However, the liabilities side of the "combined" financial statement differed radically from that of a consolidated statement of financial condition in that the exact amount of the public's interest in the underlying corporations was not disclosed. The "combined" statement lumped together in one sum the total net worth of the group of companies and no segregation was made on the balance sheet of the dollar amount applicable on the one hand to Atlas Corporation's stock and on the other hand to the capital stocks of the subsidiary companies in the hands of the public. The report did not contain any indication of the fact that the interest of Atlas Corporation in the net assets of the combined companies was equivalent, as has already been indicated, to only approximately 30% of the net assets. In sum, the combined statement conveyed substantially the same information as a consolidated statement would have with reference to the total assets of the group of companies but differed from a consolidated statement in that it did not at all indicate the respective portion of the net assets applicable to the interest of the Atlas Corporation stock and to the stock of the controlled investment companies held by the public.

No precedent can be found for the use of the term "combined balance sheets." Rodney F. Starkey, of Price, Waterhouse & Co., testified with reference to a similar balance sheet utilized by The Equity Corporation in connection with its exchange offers that he did not know what meaning might be conveyed to the investor by the phrase "combined balance sheet":

Q. * * * Now, will you just elaborate a little for me upon what the functions of a consolidated balance sheet are supposed to be?

A. I would say generally that a consolidated balance sheet was intended to show the picture of an enterprise, as compared to the picture of an individual entity—as I say, where they are substantially wholly owned.

Q. Where they are substantially wholly owned—always subject to the uncompromising principle that it should not be misleading?

A. For the purpose for which it is used—right.

Q. I notice you qualify your statement by saying subsidiaries which are wholly owned. Why do you insist on those qualifications?

A. Well, simply to prevent abuses of treatment of minority interest, and that is a very vague and general statement. I could not elaborate on it without having specific instances.

Q. One of the difficulties with a consolidated balance sheet is that it may create a misleading impression, in this respect: You may get a picture of the assets of the corporation which is not genuine or true, because there may be a substantial minority interest which owns a substantial interest in the company; is not that so?

A. That is very possible.

* * * * * * *

Q. In the layman's mind, looking at the balance sheet, if he is shown the total assets with a specific figure that, of course, makes an impression on him, does it not?

A. Yes.

* * * * * * *

A. I think a consolidated balance sheet, in the mind of the average layman, has a very definite significance. I think when you depart from generally accepted practice, understanding and accounting, it is well to use a different term, rather than confuse people's minds.

* * * * * * *

Q. Now, you said that you would not sign a consolidated balance sheet under the circumstances which I enumerated to you, because the words "consolidated balance sheet" had definite connotations in the minds of the public; is that not so?

A. I do not recall exactly how I said, but that sounds like a reasonable statement.

Q. Are you familiar with what connotations or inferences are present in the investor's mind when he sees the words "combined balance sheet?"

A. I do not know.

The "combined statement" by not indicating the dollar value of Atlas Corporation's interest in the combined net assets, also foreclosed any possibility of ascertaining either the asset value of the Atlas Corporation common stock or the dollar amount of the public's interest in the net assets of the controlled investment companies except by an involved computation based in part on additional information not included in the combined statement. The combined statement included a schedule indicating the number of outstanding shares of Atlas Corporation and the number of the outstanding shares of its subsidiaries held by the public. The procedure open to an investor who wished to ascertain the dollar value of the public interest in the group assets and the asset value of the Atlas Corporation common stock, involved a measure of accounting and analytical skill. It would have been at least necessary to examine the balance sheets of each of the controlled companies (which were not included in the Atlas Corporation report) in order to ascertain the asset value per share of each class of stock of the respective companies. Then it would have been necessary to multiply the per share asset value by the number of shares of the company indicated in the schedule accompanying the "combined" statement as belonging to the public. The addition of the amounts so derived for each company would have indicated the dollar amount of the public's interest in the combined assets. This dollar sum if deducted from the net assets indicated in the "combined statement" for the combined group would result in the sum applicable to the capital stock of Atlas Corporation. If there then be deducted from this figure the outstanding shares of Atlas preference stock at their value on any dissolution of the company,

the remaining sum would constitute the amount applicable to the Atlas Corporation common stock which, if divided by the number of Atlas Corporation common shares outstanding would give the per share asset value of the Atlas Corporation common stock.

The Atlas Corporation report as of December 31, 1931, containing the "combined balance sheet" was used in connection with Atlas Corporation's exchange offers. It was included in the literature sent to the stockholders of its subsidiaries in connection with its June 4, 1932, offers of exchange. These offers of exchange were made to the then existing 12 investment companies controlled by Atlas Corporation, that is, the 10 companies controlled as at December 31, 1931, and Atlantic Securities Corporation and American, British & Continental Corporation, control of which was acquired by Atlas Corporation in 1932. Each offer to the stockholders of each company indicated that simultaneous offers were being made to the stockholders of all other Atlas Corporation controlled investment companies.

Each of the June 4, 1932, offers also included a "Combined Statement of Financial Condition" of Atlas Corporation and its subsidiaries as of April 30, 1932, certified by Lybrand, Ross Bros. & Montgomery. This "combined statement," like the initial "combined statement" as at December 31, 1931, lumped together in one sum approximately $48,000,000 as the "total amount applicable to capital stock of combined companies outstanding in the hands of the public," including the capital stock of Atlas Corporation itself. Neither the circular letter containing the exchange offer nor any footnote of the "combined statement" as of April 30, 1932, revealed or even indicated the dollar amount of the net assets of the combined group of companies applicable to the shares of the subsidiary companies held by the public. And the public, as at June 3, 1932, still owned the greater portion of the assets of the combined companies. The "combined statement" as at April 30, 1932, also failed to reveal the actual existing asset value of Atlas Corporation's common stock (which was the medium of exchange offered in most cases) although, as will be seen, the offering literature did indicate the asset value of the Atlas Corporation stock which would result if all the offers of exchange made on June 4, 1932, were accepted by stockholders of the controlled companies.

Unlike the "combined" statement of condition as at December 31, 1931, the "combined" statement as at April 30, 1932, was stated in the offering literature to be a *pro forma* statement, that is, a statement which would indicate the financial position of Atlas Corporation upon the happening of a certain contingency. The contingency upon which the "combined" balance sheet was based, however, was stated only in the following sentence contained in the offering letters:

> Using the combined statement of financial condition on page 2 as the base, but adjusting the item "Investment" to the market or bid prices of the securities as of the date of this offer, there is an individual asset value of approximately $7.30 per share for the approximately 3,900,000 shares of Common Stock of Atlas * * * Corporation, if all of the holders of capital stock outstanding at the date hereof of all the companies should accept the offer.

The "combined statement," therefore, was intended to indicate the financial condition of Atlas Corporation if all of its exchange offers were accepted.

The $7.30 asset value for the Atlas Corporation common stock was a hypothetical figure. However, in the offering circulars sent to several of the nonleverage companies controlled by Atlas Corporation it might have been interpreted as an actual asset value. For example, the exchange offer sent to the stockholders of Aviation Securities Corporation stated:

> * * * In the case of your Company (Aviation Securities Corporation) you would be exchanging a stock having an asset value substantially in excess of its present market value but having a comparatively narrow market and having no so-called "leverage" * * * for a stock (Atlas Corporation common stock) which has a broader market and has a substantial "leverage" because of its Preference Stock and which is quoted on the market at a lesser discount from asset value as indicated above.

The only asset value mentioned for the Atlas Corporation common stock in the offering circular was the hypothetical figure of $7.30 per share. Since the market price of Atlas Corporation common stock was then $5 per share, the stock then was apparently selling at a discount from its hypothetical asset value stated in the offer. Actually, the asset value of the common stock of Atlas Corporation on June 4, 1932, based on its own assets and evaluating its holdings of the securities of its subsidiary investment companies at their ultimate asset value, was $2.97 per share. The Atlas Corporation common stock therefore was selling on the market at a substantial premium over its existing asset value possibly due to some extent at least to the activity of Allied General Corporation, in the market purchasing of such shares.

The cardinal assumption made in the preparation of the Atlas Corporation *pro forma* "combined" balance sheet was that all of the exchange offers would be accepted, a fact unlikely of attainment. The exchange offers themselves stated "that it is not expected that all of the holders of shares of various companies will avail themselves of the offers and it is only desired that those shareholders do so who believe that the exchange will be to their advantage." Moreover, the *pro forma* combined balance sheet would not accurately reflect the condition of Atlas Corporation even if it obtained sufficient exchanges of its controlled companies' stock to effect their merger, consolidation, or liquidation. Upon a merger or consolidation, some stockholders would demand the right to receive in cash the appraised value of their shares; on any dissolution of the controlled companies minority stockholders would be entitled to receive their pro rata share of the corporate assets. Finally, as this Commission has said with reference to a similar combined balance sheet issued by The Equity Corporation, "the fact remains that the *pro forma* combined statement was predicated on the assumptions both that the exchange program would be completed within a reasonable time and that it would be accomplished on the basis of the ratios first proposed. In other words, it assumed completion of the exchange program within such period of time that any material change in the value of the assets or the amount of the liabilities of the companies would be unlikely." However, Atlas Corporation continued until the middle of 1933 to make exchange offers for the stock of the companies included in its June 4, 1932, offer and in several cases the terms of the offers were changed.

Mr. Odlum, although conceding these difficulties were involved in the use of the *pro forma* combined statement, asserted that the "combined balance sheet" was approved by the accounting firm of Lybrand, Ross Bros. & Montgomery and the "combined balance sheet" was the only method of portraying to the stockholders of the Atlas Corporation's controlled investment companies its financial condition in the event of the success of its exchange program. However, the combined balance sheet indicated only the maximum range of possible advantage to the holders of the subsidiary investment company stocks who accepted the exchange offers. In addition to the combined balance sheet, no statement of the financial condition of Atlas Corporation itself based on its own assets and evaluating its holdings of the securities of its subsidiaries at their ultimate asset value was included in the offering literature. Such a statement would have revealed the then actual asset value of Atlas Corporation's common stock and would have indicated the dollar amounts of the assets in the combined statement then actually applicable to Atlas Corporation itself. The investor would then have before him the minimum as well as the maximum range of advantage in the acceptance of the Atlas Corporation's offer. He would be enabled, by a simple calculation, to determine the extent of the public's ownership interest in the combined assets, a fact of importance in attempting to gauge the probability of the eventual success of the exchange program. Obviously, the greater the proportion of the total assets owned by the public, the less likely would be the complete success of the exchange program. The investor could also ascertain if a statement of the financial condition of Atlas Corporation alone had been included in the solicitation literature, that the complete success of the offers would more than double the asset value of the existing Atlas Corporation common shares, whereas in many cases even on the basis of $7.30 as the asset value of the Atlas Corporation common stock, exchanging stockholders of the controlled companies would suffer losses in asset value.

The Equity Corporation, in connection with its offers of exchange made in 1933 for the shares of its controlled investment companies, Yosemite Holding Corporation, Chain & General Equities, Inc., Interstate Equities Corporation, and Allied General Corporation, also made use of "Combined Statements of Assets and Liabilities."

Several of the *pro forma* "Combined Statements of Assets and Liabilities" of The Equity Corporation and its controlled companies, Allied General Corporation, Yosemite Holding Corporation, Chain & General Equities, Inc., and Interstate Equities Corporation, were certified by Price, Waterhouse & Co. These combined statements did not reveal clearly that, of the combined assets of approximately $5,500,000 owned by all of the companies including The Equity Corporation itself, only $300,000 of such assets were allocable to the securities of The Equity Corporation and the remainder of such assets were applicable to public investors who held the preferred stocks of the companies controlled by The Equity Corporation. In a footnote to several of the combined statements, however, it was stated that substantially the entire assets of the combined companies were applicable to the stock of the subsidiary companies held by the public. Moreover, these combined statements were prepared by

Price, Waterhouse & Co. notwithstanding the fact that the accounting firm had refused to prepare a consolidated statement of financial condition for The Equity Corporation and its controlled companies on the ground that "in view of the outstanding capital stock held by outsiders we are of the opinion that the preparation of a consolidated balance sheet of The Equity Corporation and the * * * four companies is not in accordance with good accounting practice." And although the "combined statements" were indicated to be *pro forma* statements of the financial condition of The Equity Corporation if all of its exchange offers were accepted, both Rodney F. Starkey of Price, Waterhouse & Co. and W. F. Best, the treasurer of The Equity Corporation, conceded that it was highly improbable that all of the exchange offers would be accepted by the stockholders of the subsidiaries of The Equity Corporation. Furthermore, Mr. Starkey conceded that the terms of the exchange offers would probably be changed from time to time with a consequent alteration in the number of shares of stock of The Equity Corporation which would have to be issued in such exchanges. In other words, since the ultimate scope of The Equity Corporation's exchange program and the details of its execution differed materially from those assumed in the preparation of the "combined statements," such statements would not reflect even approximately the condition of The Equity Corporation at the conclusion of the exchange program.

The Equity Corporation also included in its exchange offer circulars a "Statement of Combined Portfolio" of itself and its subsidiaries which suggested that The Equity Corporation itself possessed a large, well-diversified portfolio. In fact, The Equity Corporation's assets at the inception of its exchange program consisted only of its holdings of 67% of the preferred, 70% of the Class A, and 72% of the common stock of Allied General Corporation, and 61% of the common and 17% of the preferred stocks of Yosemite Holding Corporation. The securities listed in the "Combined Statement of Portfolio" belonged almost exclusively to Interstate Equities Corporation, the negative asset value common stock of which was held by another subsidiary of The Equity Corporation. The preferred stock of Interstate Equities Corporation which was 95% owned by the public would have been entitled to all of the company's assets if it had been dissolved at the date that the "Combined Statement of Portfolio" was included in the exchange offer solicitation literature. Nevertheless, officials of The Equity Corporation, in answer to inquiries of stockholders of its subsidiaries, stated that "The Equity Corporation being a much larger corporation its diversification of investments should work out to the advantage of the holders of the stock * * *."

Appendix P

EASTERN UTILITIES INVESTING CORPORATION—DEVICES UTILIZED TO EXCUSE THE EXCLUSION OF EASTERN UTILITIES INVESTING CORPORATION AND GENERAL GAS & ELECTRIC CORPORATION FROM THE CONSOLIDATED STATEMENTS OF ASSOCIATED GAS & ELECTRIC COMPANY; ALLOCATION TO SURPLUS ACCOUNT OF ALL CONTRIBUTED CAPITAL EXCEPT A NOMINAL PART [1]

As of August 1927, the entire voting stock of Eastern Utilities Investing Corporation had been placed in Eastern Utilities Investing Trust subject to an option which Eastern Utilities Investing Trust granted to Associated Gas and Electric Company to repurchase the stock at the price it cost Eastern Utilities Investing Trust to acquire the stock. This voting stock of Eastern Utilities Investing Corporation remained in that trust until March 1932 and during that period the option was continued in effect. Associated Gas and Electric Company, although it did not actually reacquire the control stock until March 1932, always had the power to obtain control at any time. Yet, by virtue of this option device whereby technical control was transferred although actual control was retained, the statement of Eastern Utilities Investing Corporation was not consolidated with Associated Gas and Electric Company and a separate report on Eastern Utilities Investing Corporation was not furnished as part of Associated Gas and Electric Company's annual report. Eastern Utilities Investing Corporation held large blocks of Associated Gas and Electric Company securities in its portfolio. In addition, Eastern Utilities Investing Corporation, as will be described in greater detail hereafter, was caused to purchase $26,000,000 of securities of General Gas & Electric Corporation, including one-half of the control stock of that corporation. By this transfer, Associated Gas and Electric Company avoided the inclusion of General Gas & Electric Corporation in its own consolidated statement and obviated the necessity of furnishing separate reports of General Gas & Electric Corporation as part of Associated Gas and Electric Company's annual reports.

At the end of 1929, Eastern Utilities Investing Corporation and General Gas & Electric Corporation held a total of $133,312,844 of the debentures and stocks of Associated Gas and Electric Company. Yet the fact that Associated Gas and Electric Company did not technically hold the voting control of these two companies permitted Associated Gas and Electric Company to exclude both Eastern Utilities Investing Corporation and General Gas & Electric Corporation from the 1929 consolidated financial statements of Associated Gas and Electric Company. As a direct result of this failure to include these two companies in the consolidated statements of the top company, the capitalization and surplus of Associated Gas and Electric Company, indicated as

[1] Excerpts from Chapter II of this part of the report, p. 624 et seq.

$500,688,742, were inflated to the extent of the cross-holdings, namely, $133,312,844. The assets shown in the consolidated balance sheet of Associated Gas and Electric Company were similarly inflated by this procedure.

So, both the capitalization and assets were made to appear about $130,000,000 greater than they would have been in an Associated Gas and Electric Company statement consolidating General Gas & Electric Corporation and Eastern Utilities Investing Corporation with the balance of the "System" controlled by Associated Gas and Electric Company. The prospective investors in Associated Gas and Electric Company securities may have been impressed by this seemingly larger company and by the lower ratio of debt to assets which the $130,000,000 increase in both sides of the balance sheet indicated. More specifically, the consequence of these devices was that no disclosure was made of the fact that Associated Gas and Electric Company, having capital and funded debt and surplus of $500,688,742, held through two subsidiaries its own securities carried by the controlled companies at a value of $133,312,844. Furthermore, a complete consolidation would have prevented the inflation of the published income account of Associated Gas and Electric Company by that substantial part which was represented by payments of interest and dividends by Associated Gas and Electric Company, Eastern Utilities Investing Corporation, and General Gas & Electric Corporation to each other.

The $5.50 prior preference stock of Eastern Utilities Investing Corporation was purchased by the "System" at $97 per share. However, the controlling interests, acting through the board of directors, allocated only $1 of the proceeds of $97 per share to stated capital, and the balance of $96 per share was allocated to capital surplus. Since the company was permitted to pay dividends out of capital surplus, the action of the board made it possible to pay preferred or common dividends out of practically all of the capital raised from this issue. Although dividends were not in fact paid out of the capital surplus account, yet this account as augmented by various later reductions in stated capital, was eventually used to absorb depreciation on securities and thus made possible the payment of dividends out of the so-called corporate surplus account. This latter account would have been insufficient for the payment of dividends if it, instead of the capital surplus account, had been utilized to absorb depreciation of securities.

The creation of this surplus illustrates the manner in which the prohibition against the payment of dividends out of capital could be avoided by the simple expedient of allocating most of the proceeds of the sale of security issues to capital surplus without knowledge or consent of the stockholders. In this way, the capital invested by the public could be paid out in dividends to insiders, or any dividends paid to the public might indicate income earned rather than partial liquidation of assets.

Despite the great importance attaching to the matter of allocation of proceeds of the sale of the prior preference stock as between capital and surplus, the question was decided by the board of directors without submission to stockholders or without even apprising the stockholders as to the allocation which would be made. Furthermore, the

allocation to capital surplus of $96 out of every $97 of the proceeds of the sale of the prior preference stock was concealed by an unusual accounting device employed in the annual report to stockholders.

Instead of the segregation customary at the time between capital and surplus, the annual reports published by Eastern Utilities Investing Corporation lumped capital and surplus so that it was impossible to ascertain therefrom the amount of surplus and the amount of capital. Neither did the annual reports disclose the stated or liquidating value of any of the company's outstanding securities. As a result, a holder of junior stock could not ascertain from the annual report the amount of the claims which were senior to his stock. For instance, the balance sheet as of December 31, 1927, lumped in one item the stated capital of the stock and the surplus of Eastern Utilities Investing Corporation, showing only "stated capital for stock and surplus" in the amount of $35,213,198.73. This figure of $35,213,198.73 appears without allocation to any particular class of stock.

To illustrate the advantage to controlling interests of having a prior position through ownership of a preference stock it is illuminating to note the division, between the controlling interests and the public, of dividends on the participating preference stock for the years 1928 through 1932. Such dividends amounted to over $5,200,000 in cash. These payments were made at the full rate of $7 per share per year up to 1932, and aggregated about $32 per share for the entire period. During this period the public never held more than 6% of this class of stock. In addition to these dividends, the "System" nevertheless still held a claim for the full value on liquidation of $7,500,000, or $100 per share. However, during these same years the amount of dividends on the Class A stock, of which the public held 22%, aggregated, on all shares outstanding, only about $415,000. Moreover, when the first dividend of the Class A stock was paid, the public held only 80 shares, but when the public held its major position in the Class A stock, no dividends at all were paid. Mr. Stix testified:

Q. Did the public get any dividends on its investment in the Eastern Utilities Investing Corporation Class A?

A. It did not.

Q. But the "System" got dividends on the Eastern Utilities Investing Corporation participating preference?

A. Yes; it did.

Q. Would you not say, then, that where one person or one system owns the controlling stock and has a preferred position in a company, that the public in between are at its mercy?

A. Sure, if the management are thieves, but if they are honest there is nothing to it.

Appendix Q

PUBLISHED STATEMENTS AND ADVERTISING SETTING FORTH THE CLAIMS OF THE MANAGEMENT OF THE UNITED FOUNDERS CORPORATION GROUP WITH RESPECT TO THE "INTERNATIONAL INVESTMENT TECHNIQUE" OF THE COMPANIES OF THE GROUP [1]

William R. Bull, Chairman of the Board of Trustees of International Securities Trust of America (later International Securities Corporation) in the published report to stockholders, under date of March 22, 1926: [2]

The use of the term "Investment Trust" in the United States has been so abused in recent years that it is necessary to emphasize that International Securities Trust of America is one of the few organizations in America which has the undoubted right properly to use the term.

International Securities Trust of America is the first general investment trust established in the United States, and is patterned closely after the British investment trusts, which have been successful over a period of approximately more than a half a century.

The essential points of similarity between British investment trusts and International Securities Trust of America are as follows:

1. Both raise funds by sale of bonds, preferred and common shares.

2. Both invest and reinvest capital so obtained internationally in a wide variety of sound securities and consistently purchase at comparatively low prices.

3. Both purchase small amounts of many different securities and avoid managerial or directive responsibilities in connection with any enterprise whose securities they may hold.

4. Both leave with the Trustees or Directors the free power of substitution.

These four characteristics are fundamental in investment trust management, and give them their unique and vital position in the modern financial system. But the use of the phrase "British type" as applied to International Securities Trust of America has been the result of necessity rather than design—it was forced upon us. Since the establishment of International Securities Trust of America, there have been a number of offerings of so-called investment trust securities which have brushed aside the experience of English and Scottish trusts to form organizations along pioneer lines and which bear no essential points of likeness to British investment trusts. They have ranged from "bankers share" companies and "stock conversion" companies to straight out-and-out holding companies controlling subsidiaries. Automobile paper and commercial credit paper companies have also adopted the name. Many of these undertakings are thoughtfully planned financial conceptions, which we may watch with interest, but they are not investment trusts, properly speaking.

[1] This subject is discussed in Sec. A; see note 23 of that section, p. 2226.

[2] Public Examination, American General Corporation, et al., Commission's Exhibit No. X3457.

The "bankers share" or "stock conversion" trusts, except in one or two instances, are no longer being actively offered on the market. The investing public is learning that the essential fact about any investment trust is a direct and continuing responsibility for the wise investment and reinvestment of capital contributed by the bond and share holders.

In accordance with its fundamental practice, the Trust has, during the past year, bought a great many different high-grade securities in depressed markets wherever they have occurred in the world, and from time to time has sold securities which have advanced through buoyant markets to a point out of line in yield, enabling the Trust to buy elsewhere securities of equal quality at lower prices. This practice has resulted in a fairly rapid rate of turnover. As is readily recognized, in order to obtain capital profits from turnover, it is necessary for the Trust to keep its investments in securities of highly marketable character. This insures to the security holders in the Trust the ability of the Trustees to liquidate its holdings promptly under almost any conceivable circumstances.

The idea, elsewhere advanced, that an investment organization cannot properly manage investments in 500 or more securities is so entirely contrary to the experience of many large British trusts, and our own life insurance companies and banks, as practically to provide its own rebuttal.

In a later letter to the stockholders of International Securities Trust of America, dated October 11, 1926, Mr. Bull gave further expression to the rationale of the Founders Group investment policy as follows: [3]

It is the well-known economic fact that business and credit conditions widely differ, from country to country at the same time that has convinced your Trustees of the wisdom of being prepared at all times to employ the capital of the Trust where, other things being equal, the best investment values may be purchased at the lowest prices.

Briefly, it is the policy of your Trust to purchase in markets which are relatively depressed and, if necessary, to liquidate securities which are relatively buoyant in price in order to be in position to take advantage to the full of opportunities arising elsewhere for purchase at less than intrinsic values. These principles of international diversification involve a process of shifting, from time to time, from one market to another. The natural result is that profits are taken on securities which have been held for some time, (the experience of your Trust points to an average of about 18 months) and have risen to a figure where it is no longer advisable to hold them in view of investment opportunities elsewhere. These profits are taken, however, not primarily for the sake of realizing a gain, but in the simple performance of the Trustees' duty to make wise use of the capital * * *.

In other words, the policies of international diversification pursued by your Trust free it from any dependence upon either the "bull" or the "bear" markets of any one country. Rather, it is the number in essence of relatively buoyant markets in some countries and relatively depressed markets in other countries which gives to International Securities Trust such welcome opportunities for safe and profitable investment and reinvestment of the capital.

In the first Annual Report to the stockholders of Second International Securities Corporation, under date of April 18, 1927, Leland

[3] Id., Commission's Exhibit No. X3457.

Rex Robinson, president of the corporation, reiterated the familiar formula as follows:[4]

An International Investment Policy

The corporation has maintained these favorable earning ratios on its total assets in part as the result of the international and thoroughly cosmopolitan character of its investment policy. Like the British investment trusts, Second International Securities Corporation buys bonds as well as preferred and common shares, spreads its holdings among many types of security issuers * * * and takes advantage of situations arising in financial centers through the world in securities and markets which afford the best investment opportunities at any time.

Under date of April 25, 1927, Louis H. Seagrave, president of American Founders Trust, reporting to the stockholders for the fiscal year ended November 30, 1926, stated:[5]

On November 30, 1926, the Trust had 282 investments in 29 different countries, diversified among government, municipal, public utility, railroad and a wide range of industrial associations. Of the 282 investments, 89 originated in the United States and 193 in other countries. Through its ownership of securities of affiliated trusts, it also had an indirect interest in the 1,059 interests of those trusts.

Organization

It has been the desire of the Trustees to build up an investment organization second to none in the world, with facilities for immediate examination and report concerning investments of every character in every stable country. The Trust has made great strides throughout the past year in setting up such an organization, and 46 officers and employees are now engaged in investment analysis or research. * * *

The economists of American Founders Trust study the foreign situation of the investment market in each country under consideration, examining such factors as interest rates, investment levels, political conditions, commercial conditions, commodity values, and foreign exchange rates. They follow the fortunes of important industries, both from a national and an international standpoint. Leaving the examination of particular stocks to the analysts, they call to the attention of the Investment Committee markets where current price levels offer probable opportunities for investment, or point out conditions indicating future decline. * * *

The trust maintains correspondent banking relations with 38 strong institutions in 16 countries, through which foreign investment purchases are made. With few exceptions, each is the leading bank in its respective country, and most of them are correspondents of the large New York banks.

Addressing the annual meeting of the stockholders of American Founders Corporation on April 8, 1929, Louis H. Seagrave, president of the corporation, stated:[6]

There is a factor in our investment policy even more important than that of immediate liquidity—namely, international diversification. If the recent break

[4] Id., Commission's Exhibit No. X3529.
[5] Id., Commission's Exhibit No. X3465.
[6] Id., Commission's Exhibit No. X3840.

in security prices had proceeded further, to real bargain levels, we could easily and promptly have provided 25 to 50 million dollars for investment here by the simple expedient of selling foreign securities unaffected by the break, and made less attractive to hold by reason of comparatively lower prices and high yield attainable in this country.

Unless one grasps the fundamental principle that an international company's funds are fluid and ready to flow to the places where prices are lowest, he will fail to appreciate the very nature and purpose of an international investment company.

* * * * * * *

In a Declining Market

A question naturally arising in the minds of many investors, and, therefore, frequently asked, is "What will happen to the earnings of your companies in a falling market?" A question of this type indicates immediately that the shareholder, or prospective investor, is thinking only in terms of the American market or New York Stock Exchange. He has perhaps failed to grasp the international aspect of the companies composing the American Founders Group, and to appreciate the remarkable effects of scaled management in timing such situations and turning them to account with better than average results.

Our shareholders should not forget that American Founders Corporation and affiliated companies benefit through markets which have declined, and that such periods offer golden opportunities for investment.

* * * * * * *

This organization looks forward to the opportunities that should be presented through a price recession in this country just as it does in 30 other countries. Of course, everyone recognizes that such a decline may have an effect on the market prices of all securities, but the holders of our own securities will benefit in the long run because of the certainty that earnings will be increased through favorable buying opportunities resulting from the depression. A substantial decline in securities prices will give us here, as it has often in other countries, the opportunity, long awaited, to buy securities at prices substantially below intrinsic values.

The investment company of the general management type, operating internationally, will therefore be enabled, when price recessions occur here, to liquidate foreign holdings and acquire substantial blocks of American securities at favorable prices.

Get Internationally Minded

The tremendous development in aviation in recent years and the realization that one must understand it, has given birth to the adage "Get Air Minded." As I read the voluminous published comment on investment "trusts" or companies, I am increasingly impressed with the great importance of American citizens "Getting Internationally Minded." By that I mean lifting their minds beyond the boundaries of the United States and seeing and understanding the important events beyond the Atlantic, Pacific, Gulf Coast, or Canadian boundary and taking them into consideration in changing investment, money, and business factors. * * *

A market relatively too high in one country or industry means nothing more than shifting investment attention to some market or field where prices or outlook are more favorable. There is never a time when securities in some im-

portant markets or industries are not distinctly "out-of-line" as compared with general prices in other markets or industries; and the broader the investment companies' range of price, the more will it be able to profit by variations from market to market at the same time—selling where prices are comparatively buoyant and buying where they are comparatively low. * * *

Investment companies in the American Founders Group are able to turn quickly, to the advantage of their shareholders, the divergent movements of securities from country to country and from industry to industry. Commanding the investment service of American Founders Corporation, they are prepared to act at once when time is vital in meeting any investment opportunity. This capacity to operate internationally has been a principal factor in their success during recent years when a policy of caution has been followed in selecting American stocks for investment.

Addressing the stockholders of American Founders Corporation on November 12, 1929, approximately two weeks after the market crash, President Louis H. Seagrave made the following encouraging prophecy:[7]

The Outlook

It is quite possible that the recently prevailing confusion in the domestic securities market will continue for some weeks and that there will be periods of improvement followed by periods of renewed decline. As to general business conditions, it is also possible that we may undergo several months during which the volume of trade is restricted and profits may be curtailed. The losses suffered by individuals in the stock market will, to some extent, affect the buying power of those who were speculating and many thousands of others to refrain from buying, especially in the lower fields. On the other hand, a large proportion of the American public suffered no loss through the stock market and others who suffered merely a paper loss, will not reduce their standards of living. If such a depression in business and trade does come, I do not believe it will be either prolonged or serious.

Profits in many lines may fall off moderately and recovery may not set in for from three to six months. While this may seem like a long time to the anxious speculator on the outlook for quick profits, it will not seem long to investors and investor corporations such as American Founders Corporation. Such periods, whenever they occur, in every country provide the best and safest opportunities for the discriminating and patient buyer of investments.

From an article entitled "Service by American Founders" which appeared in the United States Investor under date of November 9, 1929, and later was reprinted and circulated:[8]

There seems to be good reason for the general belief that this season of disaster for so many adventurers in the stock market has been the source of very satisfactory profits to the investment companies which make up the American Founders group. The statement of the president, early last week, that, including United Founders, the group had $48,000,000 of immediate cash for buying carefully selected stocks and that the affiliated companies had $40,000,000 of further cash, has been given wide currency. There is good authority also for the statement that part of this money was used in purchases around the low price levels which so soon gave way to substantially better prices. The comment, so often made, by critics of investment companies in recent months, that these organizations have had nothing but fair weather thus far, and that their real strength or weakness would never have been tested until a period of trying declines had come, has itself been put to the

[7] Id., Commission's Exhibit No. X3841.
[8] Id., Commission's Exhibit No. X3842.

test by what has happened. The American Founders group, at least, appears to have come through the ordeal in excellent fashion. The belief of its advocates, that a declining market would be for it a splendid opportunity, instead of a gruelling test, would seem to have been justified.

What Made it Ready?

As is so often the case in financial matters, the average observer has taken to heart only part of what has happened. He has made mental note of the $48,000,000 and the $40,000,000 and has been impressed by the huge buying power which the sum of these figures represents. He is inclined to pay his respects to the foresight of an organization, that in some mysterious way as it seems to him, could resist the foolish notions current for the past year in the American stock market, and could be so amazingly well prepared for action when the real opportunity came. What the average observer has quite overlooked is that the true readiness of the American Founders group was represented by a good deal more money than the two figures mentioned, big as they are, and that in reality, there was nothing mysterious or uncanny about the entire occurrence. It was not precisely a matter of daily routine, that the preparation of the group was so complete and that the results were so satisfactory, but it was not so dramatic an event in the history of the group, as some have imagined. It was only the perfectly logical result of the plan on which this type of investment group operates.

The Organization

Of course, good management and shrewd foresight are not to be denied some measure of credit, but quite as much of the result has been due to what, for want of a better term, we will call the "set-up" of the organization. Several times, during the past year, the statement has been made by some investment trust or financing company that it uses "Investment Service furnished by the American Founders Corp." That phrase is becoming so familiar as to acquire something of the nature of a slogan. It indicates a belief on the part of a number of responsible organizations that this service has particular merit. Well, that service played a very large part in the conduct of the American Founders group, during these trying experiences in the stock market, just as it does at all other times. To this service, and to the important fact that the American Founders group operates on an international basis, belongs the principal measure of credit for the substantial amount of funds ready for making advantageous purchase of securities, and for the exact knowledge which the management had of what to buy and when to do so. The series of stock-market developments which represented a cataclysm for so many people were to the American Founders group scarcely more than a normal incident in their scheme of operations.

Very few people know, we suppose, that the American Founders group has passed successfully through at least three previous experiences very like the occurrences of the past fortnight. Those critics who have so frequently reminded us, prior to the past fortnight, that the investment trust of America had not yet been through the acid test of stock-market crashes were quite mistaken if they included the American Founders group in their reckoning. They made the common error of supposing that this group operate primarily within America, as nearly all of the other investment trusts do, and that the international activities of the group were of no more than moderate volume. On the contrary, the operations of this group abroad are a very large factor in its affairs, larger by a considerable degree in recent months, than its American undertakings. Consequently, it had had its baptism of fire in Belgium, and again in France, and in Germany on still a third occasion, before it met the same ordeal in the American market. It was no novice

in the art of preparing for stock-market crashes to its own advantage. The Investment Service of the American Founders group was not groping in the dark.

The International Basis

What that service consists of can be simply stated. First of all, it represents constant contact with investment markets in most of the principal countries of the world. It knows the good investments of Germany and Great Britain and Europe generally and the investments of Japan and South America just as thoroughly as it knows the investments of the United States. It has the machinery for investing in all of these countries, its correspondents among foreign banks and banking houses, and it deals largely with these correspondents. The fact that in some principal cities of Europe, the companies which comprise the American Founders group are the very best customers which the leading bank or banking house has, will give some idea of the largeness of the international aspect of this group's activities.

I explained in an earlier article the big principle back of all this. The low-price levels and high-price levels of the stock markets of the world come at quite different times. When securities are high in one country and will presently decline, they are distinctly cheap in other countries and are certain to advance in value. A company or group that is constantly familiar with the markets of many nations knows where securities are cheap and can move its funds to such markets. Then, when those markets advance and profits are available, it can move to those other markets which by this time have become attractive. In this simple principle is the explanation of the fact that the American Founders group had only a small part of its portfolio invested in American securities when the stock market breaks occurred and thus could not suffer heavily in the decline. And the same principle explains the still more interesting fact that the true buying power of the group in recent weeks has been far greater than even the sum of $48,000,000 and the $40,000,000 so often mentioned. The group could and did dispose of a considerable number of foreign investments to good advantage, and made the proceeds available for use in America if that proved desirable.

The "Set-Up"

One can get a better understanding of all this by a glance at the "set-up" of the organization. Of course, the American Founders Corporation has officers, directors, and committees. So do the British investment trusts, which even the critics of our American trusts are inclined to hold in high regard. To be perfectly frank, the weakness of British trusts in recent years has been that their set-up has included little more than this. They have operated in an international way, but they have relied mainly upon the knowledge and the contacts of individual directors for shaping their affairs in any particular market. Thus, one director would know Japan and have his contacts there, another would be equally well situated as regards the Balkans, and a third as regards South America.

The American Founders Corporation has directors with international contacts, but its operations are based upon the experience and the contacts and the research of a much larger body of men. In round figures, the corporation has an operating expense of $1,000,000 a year. Not all of it is the result of research and investment expense, but much of it is due to those items. The men who have built the big structure which the American Founders Corporation and its associated companies now represent, had more than the normal amount of human courage when they created so much of an organization, but the hundreds of millions of resources which are invested largely upon the research and the judgment of this organization, gives some idea of the confidence which this organization inspires.

An Economics Department

Broadly speaking, the "set-up" is somewhat like this. An economics department investigates fundamental conditions of countries and of world-wide market conditions for particular commodities. It undertakes, for instance, to discover whether markets and conditions in Italy or Japan are attractive for an investment; or, to determine whether market conditions for nitrates, with the German chemists pitting their skill against the natural advantages of Chile, makes the shares of nitrate companies a purchase. Then, there is the department which analyzes the records and prospects of companies. From this department comes reports on steel companies in Belgium, chemical companies in Germany, textile concerns in Japan, brewing companies in Austria, public utilities in Italy, coal companies in Czechoslovakia. The reports are not just clever arrays of figures, analyzed from this or that angle. The men who prepare them know a good deal more about these companies than their figures. Among the analysts are natives of the countries concerned, familiar with the properties of the companies and with the men who operate them. They are British and French and German and Japanese themselves. The good fortune of American Founders in being quite out of the shares of a great Austrian bank six full months before it came to grief, while some of the shrewdest American bankers, with foreign alliances, were quite unaware that such trouble was impending, is only one example among many of the intimate knowledge which the "Investment Service of the American Founders Corporation" has about international investments.

The Specialists

Still another department consists of the specialists in different classes of American investments, the man who knows public utilities, another who knows the railroads, a third who knows the mining and oil companies, or a fourth who knows the banks and insurance companies. These men are much more than students of annual reports. Without belittling the value of balance sheets and income statements and the stories which presidents tell once a year to their stockholders, every trained investor knows that he needs something beside this for a guide. He needs what the slang phrase describes as the "low-down" on the company. The skill of the management, the condition of the property, the outlook for the business, the human organization, the research departments, the hidden reserves—all of these are things that annual reports fail to picture in any sufficient way. The specialists of the American Founders Corporation have the task of supplying this knowlege and they do. Here is a public utility whose earnings look big in the annual report, but they look much smaller when the expert of the American Founders Corporation brings to light the fact that the company is not charging off enough of its earnings to depreciation or spending enough for maintenance. Here is another public utility company whose earnings are really better than annual reports reveal, because it is spending more upon its property than depreciation or maintenance requires and thus is making the property steadily more valuable. Here are oil companies, and railroads and insurance companies, whose annual reports tell one thing, but they appear in different guise as the result of the tests which the expert applies.

The Committees

So, when the executive committee and the investment committee of the American Founders Corporation come together each morning, they have the reports and the studies of these other departments at their service. On almost

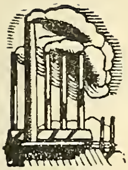
any bond or share of America or Europe or Japan or other leading countries, the economics department or the investment department or the specialists can provide the committees with charts and reports and analyses and recommendations. Suggestions will have come to hand from the numerous banks abroad, that this or that security is now attractive, and the economic and analysis department will have studied the suggestions and be ready with reports and advice. The volume of business which the group does in foreign banks makes those institutions very eager indeed to be of service. Or, the specialists will have their suggestions of opportunities in American securities. Still another department, charged with watching investments which the group already owns, will remind the committees that there has been a considerable advance in this stock or a decline worth nothing in some other, and on this the reports of the investigators will be called for. Such is the wealth of material which the "Investment Service of the American Founders Corporation" produces and the investment committee and the executive committee are really the final processes through which the material passes.

A Busy Day

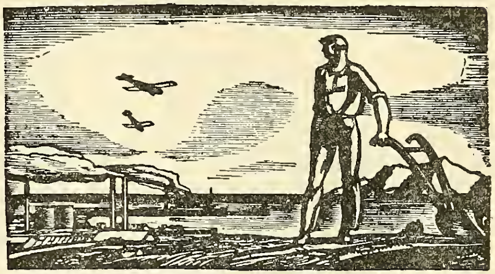
The last fortnight or so has seen the value of this organization tested by the most trying kind of a stock market. It came through the test as successfully in America as it had previously come through similar tests in Belgium, France and Germany. It had been in contact with the securities market of America all along, just as it had with the securities markets of other countries, but it had played a relatively minor role in the American market until the very day or two when the time had arrived for playing a larger part. Somebody with a gift for word painting could produce a vivid picture of the activity in the New York offices of the company on recent days when the company's larger purchases of American securities were made. They were not days of feverish excitement and confusion. The studies of the various departments, days and even months before, had made the members of the committee perfectly certain in their own mind as to what securities to buy and the prices that could properly be paid. With the specialists at their elbow and reports immediately available, if unexpected opportunities appeared, the committee did its day's work, with the results that are now known in a general way, to have been very satisfactory. For this group, at least, the transactions it made were no more to be described as stock market gambling than the purchases of grain by a miller or of iron ore by a machinery manufacturer or of paper by a publisher are gambling. They were buying in the light of expert knowledge of real values and of real earning power.

In an earlier article, in these columns, I said that declining stock markets in America should represent no source of possible anxiety to investors in the American Founders group, and that such markets would probably be a source of real advantage to the group. That statement has been borne out by recent experience. The factors which I outlined then as likely to produce this result were its policy of international rather than national investing and the thoroughness of its research and analysis. Those factors proved dependable. If the "Investment Service of the American Founders Corporation" is to be explained in simple terms, it consists of the fortunate combination of these factors with very capable and forward-looking leadership on the part of executive officers and directors of the group.

Reproduced below are reproductions of a few of the advertisements, typical of many which the United Founders Corporation group of companies published.



1921-1929
The American Founders Group of Companies



DECORATIONS BY ROCKWELL KENT • CUT IN WOOD BY J. J. LANKES

WHAT is now the American Founders group of investment companies began in April, 1921. International Securities Trust of America was then formed "to invest, sell and reinvest [its] assets ... in American and foreign bonds, stocks and other securities."

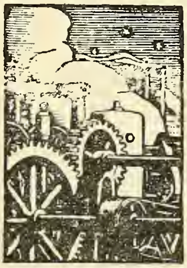
International Securities Corporation of America, the successor company, is one of four general management investment companies—often called "investment trusts"—included in the American Founders group. The group borrows its name from American Founders Corporation, whose business was established in 1922 and which provides research service and investment supervision for the affiliated companies.

The American Founders companies practise systematic investment of their funds under active and careful management, which policy has brought better than average results.

Experience and research facilities extend to over thirty of the world's security markets and to every Industry. In the principal markets the funds are distributed and redistributed, as safe and prosperous enterprises are found by the economics and investment departments of American Founders Corporation. The combined resources of the group exceed $200,000,000.

• • •

Investment bankers and banks with security departments will furnish information and counsel concerning any of the investment companies that compose this group. Or it may be obtained from Founders General Corporation, 50 Pine Street, New York City.



THE

AMERICAN FOUNDERS GROUP

Including

AMERICAN FOUNDERS CORPORATION

General Management Investment Companies

INTERNATIONAL SECURITIES CORPORATION OF AMERICA

SECOND INTERNATIONAL SECURITIES CORPORATION

UNITED STATES & BRITISH INTERNATIONAL COMPANY, LTD.

AMERICAN & GENERAL SECURITIES CORPORATION

Sharing the Prosperity of Many Companies, Many Industries, Many Countries

[From The New York Times, September 17, 1929]

153373—42——34

International Securities Trust

OF AMERICA

A MASSACHUSETTS TRUST

First among American Investment Trusts

Resources over $18,000,000

Built to Endure

Three fundamental factors of safety are built into the offerings of this pioneer American investment trust:—

Selection: Every investment owned by the International Securities Trust of America involves comprehensive research fortified by experienced judgment.

Diversification: The most thoroughgoing distribution of risk offered by any investment trust, American, Continental, or British.

Supervision: The vigilance of regional experts and active investment committees, backed by independent monthly appraisals.

Shares in this Trust thus constitute an investment which even the most cautious may

"PUT AWAY AND FORGET"

Price Per Unit (1 Share 6% Preferred and 1 Share Common) to yield currently about 6%

Send for Booklet 5-*TA*-24

American Founders Trust

A MASSACHUSETTS TRUST

FISCAL AGENT

First National Bldg.
Boston

50 Pine Street
New York

[From The New York Times, August 6, 1926]

International Securities Trust
OF AMERICA

A MASSACHUSETTS TRUST

First among American Investment Trusts

Resources over $12,000,000

The Four Essentials of a Perfect Investment

I. *Safety of Principal.*
A portfolio of more than 500 different seasoned securities.

II. *Stability of Income.*
Approximately 60% of investments in amply secured bonds. British investment trusts, following similar practices, are rated as among the most conservative and stable of London financial institutions.

III. *Assurance of Capital Profits.*
Shrewd and careful buying in the most favorable markets at home and abroad.

IV. *Salability.*
A dependable market regularly quoted.

Preferred and Common Shares

Price: Per unit of 1 Share 6½% Preferred and ½ Share Common,

$136, to yield about 6.50%

Send for Booklet 1-T.A.-21

American Founders Trust

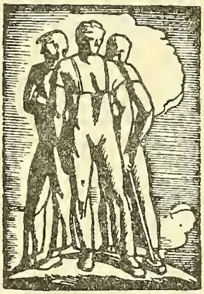
A MASSACHUSETTS TRUST

FISCAL AGENT

First National Bldg.
Boston

50 Pine Street
New York

[From The New York Times, May 14, 1926]



Permanent principles in a changing world

THE four general management investment companies in the American Founders group follow definite principles of conservative investment and broad diversification. They set a high minimum for the number of different investments and a low maximum for the amount invested in any one enterprise, industry or country. They buy both bonds and stocks.

Their portfolios are constantly supervised by American Founders Corporation, whose experience and facilities qualify it to follow every important industry in thirty of the world's security markets.

, , ,

The policy of the American Founders companies is to acquire sound holdings in this and other stable countries of the world, when prices are comparatively depressed. They readjust these investments as greater safety and advantage offer.

The four general management companies are not trading, holding or financing companies; in many ways they resemble the British investment trusts, and their only business is the investment and reinvestment of their funds.

There is an active market for the securities of the group. Information and quotations may be obtained from bankers and dealers, or from Founders General Corporation, 50 Pine Street, New York.

DECORATIONS BY ROCKWELL KENT • CUT IN WOOD BY J. J. LANKES

THE AMERICAN FOUNDERS GROUP

Including

AMERICAN FOUNDERS CORPORATION

General Management Investment Companies

INTERNATIONAL SECURITIES CORPORATION OF AMERICA
SECOND INTERNATIONAL SECURITIES CORPORATION
UNITED STATES & BRITISH INTERNATIONAL COMPANY, LTD.
AMERICAN & GENERAL SECURITIES CORPORATION

[From The New York Times, October 15, 1929]

Appendix R

Exhibit of profits from disposition of securities of founders companies and of other allied companies realized during fiscal years ended Nov. 30, 1928, 1929, and 1930

FISCAL YEAR ENDED NOV. 30, 1928

Description of Securities Sold	Sold by: American Founders Trust and Corporation	Founders General Corp.	Internat'l Sec. Corp. America	Second Internat'l Sec. Corp.	U. S. & British Internat'l Co., Ltd.	Total
Founders Companies Securities:						
United Founders Corp.:						
Common						
Common Scrip						
Rights						
Subtotal						
American Founders Corp.:						
Common		$253,937.94	$458,420.63	$87,714.25	$116,825.63	$916,898.45
Preferred		(77,557.07)	28,410.00			(49,147.07)
Allotment Ctf						
Warrants						
Rights		1,290.96				1,290.96
Common Scrip		1,385.11				1,385.11
Subtotal						870,427.45
Internat'l S. Corp. Amer.:						
Class A Common		(59.40)		(33,458.43)		(33,517.83)
Class B Common	$412,174.97	456.03		35,000.00	36,637.50	484,268.50
Preferred				(188.03)	17,048.25	16,860.22
Allotment Ctf						
Units—A & Pfd	242,406.81					242,406.81
Bonds						
Commission						
Subtotal						710,017.70

See footnotes at end of table.

Exhibit of profits from disposition of securities of founders companies and of other allied companies realized during fiscal years ended Nov. 30, 1928, 1929, and 1930—Continued

FISCAL YEAR ENDED NOV. 30, 1928

Description of Securities Sold	Sold by: American Founders Trust and Corporation	Founders General Corp.	Internat'l Sec. Corp. America	Second Internat'l Sec. Corp.	U. S. & British Internat'l Co., Ltd.	Total
American Founders Corp.—Continued.						
Second Internat'l Sec. Corp.:						
Class A Common						
Class B Common	$1, 273, 340. 12	$8, 012. 17			$12, 000. 00	$1, 293, 352. 29
Preferred						
Allotment Ctf						
Units—A & Pfd	17, 457. 56					17, 457. 56
Subtotal						1, 310, 809. 85
U. S. & British Internat'l Co., Ltd.:						
Class A Common		50, 500. 00				50, 500. 00
Class B Common	139, 323. 41					139, 323. 41
Preferred						
Units—A & Pfd	63, 970. 52			$20, 800. 05		84, 770. 57
Subtotal						274, 593. 98
American & General Sec. Corp.:						
Class A Common				49, 000. 00	50, 240. 00	99, 240. 00
Class B Common	67, 160. 00					67, 160. 00
Preferred						
Units—A & Pfd	5, 671. 50					5, 671. 50
Subtotal						172, 071. 50
American & Continental Corp.: Common W. W						
Trans-Oceanic Trust: Preferred					23, 296. 53	23, 296. 53
Investment Trust Associates:						
Common	28, 000. 00	75. 00	$535, 780. 00	250, 000. 00	100, 000. 00	913, 855. 00
Rights						
Totals—Founders Companies Securities	2, 249, 504. 89	238, 040. 74	1, 022, 610. 63	408, 867. 84	356, 047. 91	4, 275, 072. 01

Other Allied Companies Securities:						
U. S. Electric Power Corp.:						
Common W. W.	--------	--------	--------	--------	--------	--------
Warrants	--------	--------	--------	--------	--------	--------
Subtotal	--------	--------	--------	--------	--------	--------
Standard Gas & Electric Co.: Common	--------	--------	--------	--------	--------	--------
Public Utility Holding Corp.:						
Common W. W.	--------	--------	--------	--------	--------	--------
Warrants	--------	--------	--------	--------	--------	--------
Subtotal	--------	--------	--------	--------	--------	--------
U. S. & Overseas Corp.:						
Common W. W.	--------	--------	--------	--------	--------	--------
Class A	--------	--------	--------	--------	--------	--------
Subtotal	--------	--------	--------	--------	--------	--------
Totals—Other Allied Companies Securities	--------	--------	--------	--------	--------	--------
Total Profits Realized From Disposition of Securities of Founders Companies and of other Allied Companies	2, 249, 504. 89	238, 040. 74	1, 022, 610. 63	408, 867. 84	356, 047. 91	4, 275, 072. 01
End of Exhibit—For Comparison Only: Total Profits From Disposition of Securities of all Companies—Per Books	2, 937, 943. 79	238, 262. 46	2, 307, 730. 33	1, 082, 012. 09	726, 070. 62	7, 292, 019. 29

Note (1). Realized profits are exclusive of proceeds aggregating $5,619,384 received by United Founders Corporation upon disposition of rights for the purchase of U. S. Electric Power Corporation common stock.

Note (2). Figures within parentheses indicate losses.

Exhibit of profits from disposition of securities of founders companies and of other allied companies realized during fiscal years ended Nov. 30, 1928, 1929, and 1930—Continued

FISCAL YEAR ENDED NOV. 30, 1929

Description of securities sold	Sold by								Total
	American Founders Corp.	Founders General Corp.	Internat'l. Sec. Corp. America	Second internat'l. Sec. Corp.	U. S. & British Internat'l Co., Ltd.	American & General Sec. Corp.	United Founders Corp.	Investment Trust Associates	
Founders Companies Securities:									
United Founders Corp.:									
Common		$7,704,680.11	$1,681,445.12	$951,305.00	$793,465.00	$789,257.00		$2,125,141.60	$14,045,293.83
Common Scrip									
Rights		39,378.19							39,378.19
Subtotal									14,084,672.02
American Founders Corp.:									
Common		1,030,703.75					$866,910.16	466,318.76	2,363,932.67
Preferred		200,520.09						16,140.00	216,660.09
Allotment Ctf		23,234.26							23,234.26
Warrants		631.18							631.18
Rights		5,037.49							5,037.49
Common Scrip		7,088.83							7,088.83
Subtotal									2,616,584.52
Internat'l S. Corp. Amer.:									
Class A Common	$20,409.77	591.05			(110.00)			4,000.00	24,890.82
Class B Common		24,463.49		85,600.00	53,500.00			39,900.00	203,463.49
Preferred	3,457.28	(4.04)							3,453.24
Allotment Ctf	(51,202.93)	248.50							(50,954.43)
Units-A & Pfd									
Bonds	1,804.00								1,804.00
Commission	52,500.00								52,500.00
Subtotal									235,157.12
Second Internat'l Sec. Corp.:									
Class A Common	9,391.48								9,391.48
Class B Common		8,180.38			41,400.00			33,800.00	83,380.38
Preferred	(1,664.70)	38.36							(1,626.34)
Allotment Ctf	(7,024.66)								(7,024.66)

Units-A & Pfd									
Subtotal									84, 120. 86
U. S. & British Internat'l Co.:									
Class A Common	43, 708. 31	9. 52	2, 100. 00						45, 817. 83
Class B Common		953. 55						2, 100. 00	3, 053. 55
Preferred	40, 910. 27	512. 50							41, 422. 77
Units-A & Pfd	8, 064. 85								8, 064. 85
Subtotal									98, 359. 00
American & General Sec. Corp.:									
Class A Common	17, 069. 88	90. 31		(750. 00)				250, 000. 00	266, 410. 19
Class B Common		198, 617. 90						1, 200, 000. 00	1, 398, 617. 90
Preferred									
Units-A & Pfd	13, 726. 30	. 18			(750. 00)			12, 040. 00	25, 016. 48
Subtotal									1, 690, 044. 57
American & Continental Corp.:									
Common W. W	1, 156, 975. 26	11, 251. 71							1, 168, 226. 97
Trans-Oceanic Trust-Preferred					8, 458. 36				8, 458. 36
Investment Trust Associates:									
Common		121, 005. 99	1, 750, 000. 00	1, 050, 000. 00	700, 000. 00	1, 114, 120. 25	311, 517. 46		5, 046, 643. 70
Rights		4, 920. 28	74, 623. 75		35, 000. 00	17, 500. 00			132, 044. 03
Subtotal									5, 178, 687. 73
Totals—Founders Companies Securities	1, 308, 125. 11	9, 382, 153. 58	3, 508, 168. 87	2, 086, 155. 00	1, 630, 963. 36	1, 920, 877. 25	1, 178, 427. 62	4, 149, 440. 36	25, 164, 311. 15
Other Allied Companies Securities:									
U. S. Electric Power Corp.:									
Common W. W	1, 208, 225. 06	(737, 989. 99)	86, 400. 00				533, 691. 02	14, 976. 00	1, 105, 302. 09
Warrants							23, 758. 70		23, 758. 70
Subtotal									1, 129, 060. 79
Standard Gas & Electric Co.:									
Common	350, 857. 95		608, 699. 46	181, 249. 00	98, 480. 10	253, 851. 85	1, 308, 462. 00	194, 870. 75	2, 996, 471. 11
Public Utility Holding Corp.:									
Common W. W	1, 602, 316. 55	(14, 305. 36)	1, 166, 960. 54	128, 451. 32	128, 131. 32	171, 738. 37	3, 318, 549. 83	128, 131. 32	6, 629, 973. 89
Warrant		50. 00							50. 00
Subtotal									6, 630, 023. 89

Exhibit of profits from disposition of securities of founders companies and of other allied companies realized during fiscal years ended Nov. 30, 1928, 1929, and 1930—Continued

FISCAL YEAR ENDED NOV. 30, 1929

Description of securities sold	Sold by: American Founders Corp.	Founders General Corp.	Internat'l. Sec. Corp. America	Second internat'l. Sec. Corp.	U. S. & British Internat'l Co., Ltd.	American & General Sec. Corp.	United Founders Corp.	Investment Trust Associates	Total
Other Allied Companies Securities:—Continued.									
U. S. & Overseas Corp.:									
Common W. W.		$12.50		$99,243.75	$74,081.25	$74,081.25		$123,468.25	$370,887.00
Class A	($3,000.00)								(3,000.00)
Subtotal									367,887.00
Totals—Other Allied Companies Securities	3,158,399.56	(752,232.85)	$1,862,060.00	408,944.07	300,692.67	499,671.47	$5,184,461.55	461,446.32	11,123,442.79
Total Profits realized from disposition of Securities of Founders Companies and of other Allied Companies	4,466,524.67	8,629,920.73	5,370,228.87	2,495,099.07	1,931,656.03	2,420,548.72	6,362,889.17	4,610,886.68	36,287,753.94
End of Exhibit—For Comparison Only:									
Total Profits from Disposition of Securities of all Companies—Per Books	4,393,067.09	8,728,310.33	5,937,891.66	2,232,945.18	2,001,347.63	3,044,697.45	7,406,092.76	4,814,736.27	38,559,088.37

FISCAL YEAR ENDED NOV. 30, 1930

Description of securities sold	American Founders Corp.	Founders General Corp.	Internat'l. Sec. Corp. America	Second internat'l. Sec. Corp.	U. S. & British Internat'l Co., Ltd.	American & General Sec. Corp.	United Founders Corp.	Investment Trust Associates	Total
Founders Companies Securities:									
United Founders Corp.:									
Common		$2,405,512.49							$2,405,512.49
Common Scrip		2,793.59							2,793.59
Rights		29,904.66							29,904.66
Subtotal									2,438,210.74

American Founders Corp.:									
Common		(4,615.44)						$3,176.88	(1,438.56)
Preferred		(39,394.12)					$4,616.66		(34,777.46)
Allotment Ctf.		(1,326.21)					210.85		(1,115.36)
Warrants		30,415.40							30,415.40
Rights		18,088.64							18,088.64
Common Scrip		1,529.96							1,529.96
Subtotal									12,702.62
Internat'l. S. Corp. Amer.:									
Class A Common	$853.22	(30.00)					(1,764.00)		(940.78)
Class B Common	(35.44)	1,533.65							1,498.21
Preferred	11,085.87	(5.90)							11,079.97
Allotment Ctf.									
Units—A & Pfd.									
Bonds	3,566.50								3,566.50
Commission									
Subtotal									15,203.90
Second Internat'l. Sec. Corp.:									
Class A Common	26.79								26.79
Class B Common	.02	234.61					(1,660.00)		(1,425.37)
Preferred	2,567.79	(4.71)							2,563.08
Allotment Ctf.									
Units—A & Pfd.									
Subtotal									1,164.50
U. S. & British Internat'l. Co.:									
Class A Common	1,018.67	(25.00)							993.67
Class B Common	(4,144.06)	4,516.06							372.00
Preferred	452.48	(9.37)							443.11
Units—A & Pfd.									
Subtotal									1,808.78
American & General Sec. Corp.:									
Class A Common	1,981.46						(1,000.00)		981.46
Class B Common	(444.54)	(53.26)					(1,500.46)		(1,998.26)
Preferred	3,251.94								3,251.94
Units—A & Pfd.	33.38								33.38
Subtotal									2,268.52
American & Continental Corp.:									
Common W. W.	(7,034.31)	(42,721.99)							(49,756.30)

Exhibit of profits from disposition of securities of founders companies and of other allied companies realized during fiscal years ended Nov. 30, 1928, 1929, and 1930—Continued

FISCAL YEAR ENDED NOV. 30, 1930—Continued

Description of securities sold	Sold by								Total
	American Founders Corp.	Founders General Corp.	Internat'l. Sec. Corp. America	Second internat'l. Sec. Corp.	U. S. & British Internat'l Co., Ltd.	American & General Sec. Corp.	United Founders Corp.	Investment Trust Associates	
Founders Companies Securities—Con.									
Trans-Oceanic Trust: Preferred					($9,836.69)				($9,836.69)
Investment Trust Associates:									
Common		($2,216.55)	$777,747.84	$278,600.00	334,960.00	$306,880.00	($50,610.44)		1,645,360.85
Rights		(413.53)							(413.53)
Subtotal									1,644,947.32
Totals—Founders Companies Securities	$13,179.77	2,403,712.98	777,747.84	278,600.00	325,123.31	306,880.00	(51,707.39)	$3,176.88	4,056,713.39
Other Allied Companies Securities:									
U. S. Electric Power Corp.:									
Common W. W	23,654.47	(291,034.45)		88,200.00	73,500.00	73,500.00	256,581.19		224,401.21
Warrants	13,203.13	5,710.48	99,600.00	49,800.00	49,800.00	49,800.00	13,203.12	49,800.00	330,916.73
Subtotal									555,317.94
Standard Gas & Electric Co.: Common	(65,325.06)		(228,970.60)	(192,233.68)	(158,921.04)	(243,471.17)			(888,921.55)
Public Utility Holding Corp.:									
Common W. W	88,275.59	642,363.28		88,000.00	66,000.00	59,710.56	128,925.00	88,000.00	1,161,274.43
Warrants		1,107.50					301,783.82		302,891.32
Subtotal									1,464,165.75
U. S. & Overseas Corp.:									
Common W. W	64,900.00	(12.50)	(6,253.21)	(117,818.17)	87,089.75	86,865.75	179,956.79	207,744.25	738,109.00
Class A	195,109.38								195,109.38
Subtotal									933,218.38
Totals—Other Allied Companies Securities	319,817.51	358,134.31	(135,623.81)	151,584.49	117,468.71	26,405.14	880,449.92	345,544.25	2,063,780.52

Total Profits Realized From Disposition of Securities of Founders Companies and of other Allied Companies	332, 997. 28	2, 761, 847. 29	642, 124. 03	420, 184. 49	442, 592. 02	333, 285. 14	828, 741. 53	348, 721. 13	6, 120, 493. 91
End of Exhibit—For Comparison Only:									
Total Profits from Disposition of Securities of all Companies—Per Books	(261, 746. 30)	2, 691, 262. 60	(2, 590, 008. 11)	(1, 619, 672. 02)	(997, 882. 84)	(1, 402, 333. 63)	1, 237, 977. 32	381, 028. 63	(2, 561, 374. 35) (see comments)

Exhibit of profits from disposition of securities of founders companies and of other allied companies realized during fiscal years ended Nov. 30, 1928, 1929, and 1930—Continued

SUMMARY, 1928-30

Description of Securities Sold	Sold by								All Companies
	American Founders Corp.	Founders General Corp.	Internat'l Sec. Corp. America	Second Internat'l Sec. Corp.	U. S. & British Internat'l Co., Ltd.	American & General Sec. Corp.	United Founders Corp.	Investment Trust Associates	
Founders Companies Securities:									
United Founders Corp.:									
Common		$10, 110, 192. 60	$1, 681, 445. 12	$951, 305. 00	$793, 465. 00	$789, 257. 00		$2, 125, 141. 60	$16, 450, 806. 32
Common Scrip		2, 793. 59							2, 793. 59
Rights		69, 282. 85							69, 282. 85
American Founders Corp.:									
Common		1, 280, 026. 25	458, 420. 63	87, 714. 25	116, 825. 63		$866, 910. 16	469, 495. 64	3, 279, 392. 56
Preferred		83, 568. 90	28, 410. 00				4, 616. 66	16, 140. 00	132, 735. 56
Allotment Ctf		21, 908. 05					210. 85		22, 118. 90
Warrants		31, 046. 58							31, 046. 58
Rights		24, 417. 09							24, 417. 09
Common Scrip		10, 003. 90							10, 003. 90
Internat'l S. Corp. Amer.:									
Class A Common	$21, 262. 99	501. 65		(33, 458. 43)	(110. 00)		(1, 764. 00)	4, 000. 00	(9, 567. 79)
Class B Common	412, 139. 53	26, 453. 17		120, 600. 00	90, 137. 50			39, 900. 00	689, 230. 20
Preferred	14, 543. 15	(9. 94)		(188. 03)	17, 048. 25				31, 393. 43
Allotment Ctf	(51, 202. 93)	248. 50							(50, 954. 43)
Units—A. & Pfd	242, 406. 81								242, 406. 81
Bonds	5, 370. 50								5, 370. 50
Commission	52, 500. 00								52, 500. 00
Second Internat'l Sec. Corp.:									
Class A Common	9, 418. 27								9, 418. 27
Class B Common	1, 273, 340. 14	16, 427. 16			53, 400. 00		(1, 660. 00)	33, 800. 00	1, 375, 307. 30
Preferred	903. 09	33. 65							936. 74
Allotment Ctf	(7, 024. 66)								(7, 024. 66)
Units—A & Pfd	17, 457. 56								17, 457. 56
U. S. & British Internat'l Co.:									
Class A Common	44, 726. 98	50, 484. 52	2, 100. 00						97, 311. 50

Class B Common	135, 179. 35	5, 469. 61						2, 100. 00	142, 748. 96
Preferred	41, 362. 75	503. 13							41, 865. 88
Units—A & Pfd	72, 035. 37			20, 800. 05					92, 835. 42
American & General Sec. Corp.:									
Class A Common	19, 051. 34	90. 31	(750. 00)	49, 000. 00	50, 240. 00		(1, 000. 00)	250, 000. 00	366, 631. 65
Class B Common	66, 715. 46	198, 564. 64					(1, 500. 46)	1, 200, 000. 00	1, 463, 779. 64
Preferred	3, 251. 94								3, 251. 94
Units—A & Pfd	19, 431. 18	. 18			(750. 00)			12, 040. 00	30, 721. 36
American & Continental Corp.:									
Common W. W	1, 149, 940. 95	(31, 470. 28)							1, 118, 470. 67
Trans-Oceanic Trust: Preferred					21, 918. 20				21, 918. 20
Investment Trust Associates:									
Common	28, 000. 00	118, 864. 44	3, 063, 527. 84	1, 578, 600. 00	1, 134, 960. 00	1, 421, 000. 25	260, 907. 02		7, 605, 859. 55
Rights		4, 506. 75	74, 623. 75		35, 000. 00	17, 500. 00			131, 630. 50
Total—Founders Companies Securities	3, 570, 809. 77	12, 023, 907. 30	5, 307, 777. 34	2, 774, 372. 84	2, 312, 134. 58	2, 227, 757. 25	1, 126, 720. 23	4, 152, 617. 24	33, 496, 096. 55
Other Allied Companies Securities:									
U. S. Electric Power Corp.:									
Common W. W	1, 231, 879. 53	(1, 029, 024. 44)	86, 400. 00	88, 200. 00	73, 500. 00	73, 500. 00	790, 272. 21	14, 976. 00	1, 329, 703. 30
Warrants	13, 203. 13	5, 710. 48	99, 600. 00	49, 800. 00	49, 800. 00	49, 800. 00	36, 961. 82	49, 800. 00	354, 675. 43
Standard Gas & Electric Co.:									
Common	285, 532. 89		379, 728. 86	(10, 984. 68)	(60, 440. 94)	10, 380. 68	1, 308, 462. 00	194, 870. 75	2, 107, 549. 56
Public Utility Holding Corp.:									
Common W. W	1, 690, 592. 14	628, 057. 92	1, 166, 960. 54	216, 451. 32	194, 131. 32	231, 448. 93	3, 447, 474. 83	216, 131. 32	7, 791, 248. 32
Warrants		1, 157. 50						301, 783. 82	302, 941. 32
U. S. & Overseas Corp.:									
Common W. W	64, 900. 00		(6, 253. 21)	217, 061. 92	161, 171. 00	160, 947. 00	179, 956. 79	331, 212. 50	1, 108, 996. 00
Class A	192, 109. 38								192, 109. 38
Total—Other Allied Companies Securities	3, 478, 217. 07	(394, 098. 54)	1, 726, 436. 19	560, 528. 56	418, 161. 38	526, 076. 61	5, 763, 127. 65	1, 108, 774. 39	13, 187, 223. 31
Grand total	7, 049, 026. 84	11, 629, 808. 76	7, 034, 213. 53	3, 334, 901. 40	2, 730, 295. 96	2, 753, 833. 86	6, 889, 847. 88	5, 261, 391. 63	46, 683. 319. 86

Source: Public Examination, American General Corporation et al., Commission's Exhibit No. 3732.

Appendix S

TESTIMONY OF LOUIS H. SEAGRAVE AND ROYAL E. T. RIGGS WITH RESPECT TO THE CIRCUMSTANCES SURROUNDING THE FORMATION OF FOUNDERS GENERAL CORPORATION AND ITS RELATIONSHIP TO THE FOUNDERS GROUP[1]

The circumstances surrounding the formation of Founders General Corporation and its relationship to the Founders group are set forth in the following testimony:[2]

Q. Now, we come to the creation of Founders General. Mr. Seagrave, Mr. Riggs evidently is desirous of having you state the reasons for the formation of Founders General, and I would be very glad to have you do so.

A. I joined these companies, as you recall, in 1925, that is, I joined the American Founders Trust, and the following year I was made president of the company. There were some things I wanted to see changed, and during the next year or two we succeeded in getting a good many of them changed. As time went on I grew to dislike the activity of the American Founders Trust in the distribution of securities, particularly I did not like its buying and selling its own securities. The question was what could be done. Well, during those years a great deal was done in the hopes that we would succeed in getting a large, able, distributing company, or group of them, who could and would undertake the distribution and leave us entirely free to devote ourselves entirely to the management of the portfolios and the occasional arrangement for some additional investment capital. We succeeded in the sale of bonds, or, rather, debentures. Harris, Forbes undertook those and raised some capital for us. We made some progress in the sale of units, preferred and common shares, through Albert Wagg, Ames Emerich, Tucker Anthony, and we made comparatively little progress in the distribution of common shares. The types of companies that we wanted to undertake this were devoting themselves chiefly to senior security distribution at that time.

So we had a great many discussions that lasted months and months as to what could be done about it. The suggestion was made that we form a company, invite some of the officers and directors to make an investment in it, and let that company undertake entirely separately, without any interest one way or the other, to distribute through dealers the securities of this group.

Counsel pointed out, and very properly, I think, that that might open us to the charge that the insiders had formed a company in the hopes of marketing the securities to make money for themselves. So, as a compromise of our views in order to segregate this activity from that of American Founders, we formed this subsidiary. It was not an ideal arrangement and yet it seemed the best arrangement at the time.

By Mr. RIGGS:

Q. Now, was that formed after consultation with counsel, that is, myself, who advised you that the company was a subsidiary, wholly owned subsidiary, and

[1] This testimony relates to the subject discussed supra, p. 2300 et seq.

[2] Public Examination, American General Corporation, et al., at 24102 et seq.

advised, as far as distribution was concerned, that it would be proper for it to distribute stock of American Founders as well as stock of other companies?

A. That is my recollection.

Q. And was that advice also to the effect that the Founders General Corporation should not go permanently long on the shares of American Founders Corporation's affiliates?

A. That is a fact.

Q. Is it a fact that when that stock was bought subsequently by Founders General of American Founders Corporation, and indeed of all the other corporations, it was bought for the purpose of resale to the public?

A. That is correct.

Q. And is it a fact that there were other companies which you knew of at that time, wholly owned subsidiaries, utilities or others, who were engaged in the same distribution?

A. Yes; that is right.

By Mr. Stern:

Q. I would like to ask one question. Did you have the advice of counsel that it was entirely proper and appropriate to sell securities of American Founders through Founders General?

Mr. Riggs. I will answer that, that he did.

Mr. Stern. Was the advice in writing, Mr. Riggs?

Mr. Riggs. No; I do not think so.

* * * * * * *

Mr. Stern. Did you believe that that was a good practice, Mr. Riggs?

Mr. Riggs. I believed that it was a better practice than having several of the directors and officers of the company form a company which would conduct the same business and subject them to the charge of making commissions upon every share of stock that was sold. I believe in this practice that the stockholders would benefit in that any profits that were made upon the distribution of securities and the dealing in securities would belong to the stockholders as a whole and not to any insiders in the group.

Mr. Stern. Did you realize, Mr. Riggs, at the time you gave that advice, that the profits from what was in effect the company trading in its own stock would appear in the income account of the company in the form of dividends received?

Mr. Riggs. I think I did in that this company was regarded always as an entirely separate and distinct company from its parent. It had separate directors, two or three directors of the group, of the parent Founders were on the Board, it had separate officers, an entirely separate corps of employees. It was in a separate business from American Founders, and by the advice of accountants subsequently its accounts were not consolidated with those of American Founders, inasmuch as the investment of American Founders in it was small as compared to the assets of American Founders, and because it was in an entirely distinct line of business, and they accepted that advice.

Mr. Stern. We shall take up this question of consolidation in some detail later but I should like to ask you now, Mr. Riggs, did you think it was an improvement in having American Founders dealing in its own stock and setting forth those facts, perhaps, in its balance sheet, that Founders General would deal in the stock of its parent and that these dividends, because the account of the two corporations were not consolidated, there would be no disclosure in which way those dividends were arrived at?

Mr. Riggs. When you say "deal in the stock of the parents," I do not think you get the correct purpose. The purpose of the Founders General was the distribution of the stock of American Founders and of other companies in the group.

Whatever stock it purchased was not for the purpose of taking a long position, but was for the purpose of effecting either primary or secondary distribution.

Mr. STERN. Regardless of that, the fact is that what you were doing by creating a separate distribution corporation, if that corporation did make profit from the handling of the stock of its parent, which it did, those returns were shown by the parent as dividends and no one reading the report of that company could have any inkling that that amount of dividends came from the dealings in the shares of the parent; did you contemplate that?

Mr. RIGGS. I do not know whether we contemplated it at the time of the formation of Founders General, or exactly in what way the profits would be handled, but when it came to the first report, that was the way it was handled by the accountants, and we accepted it. I saw no reason for questioning their method of handling it.

Mr. STERN. And you do not today?

Mr. RIGGS. No; I do not today. I think today it would have been better that the amount of dividends received by the subsidiary should have been earmarked, but it was stated in all of the reports that this was a distribution company, that its business was separate from American Founders, and that its earnings and assets were not consolidated in American Founders.

Mr. STERN. Has it ever occurred to you, Mr. Riggs, either then or since, that if this company showed a substantial amount of income from handling the securities of its parent, that that was an income that was nonrecurrent unless its parent company could go on selling these securities forever, and when you put this amount of earnings into the income account of the parent company as a dividend, that that was a misleading situation to the stockholders?

Mr. RIGGS. That did not occur to me at all, and I do not believe it does now, because it was stated to be a distribution company. That does not mean it makes any money; that its earnings necessarily, if anybody knew what the distribution company was, whether in nature it was nonrecurrent, all profits upon the sale of securities, whether they are profit upon the sale in distribution, on receipt of the payment of a commission, or a profit in the difference between what stocks are bought and sold at, must necessarily in my opinion, be nonrecurrent.

Mr. STERN. And it is your [considered] view, Mr. Riggs, is it, that when the parent company states its dividends as its dividend figures, it does not show that those figures are coming from the Founders General and that they came from the distribution of their own securities, the securities within the group, that that is all the disclosure the stockholder should have?

Mr. RIGGS. I think today there would be no question but what there would be an earmark or a footnote to indicate the amount of dividends received from Founders General as separate from dividends received from its general portfolio. I have no doubt that the advance in the dissemination of details of earnings and assets to stockholders in the last ten years has brought that about. As to whether it would be necessary to indicate that they were nonrecurring or not, I do not agree with that, because of the very nature of the company itself, but so far as the dividends which were received by American Founders from Founders General during the year 1929, I think, upon analysis, that you will find that there was a very small proportion of those dividends made up from dealing in the parent company stock, that is, American Founders as such. The greater portion of the dividends were probably made up of profits made upon the distribution of United Founders stock, which, although it had an interest in American Founders, could not at any time during 1929 be considered as a parent. I think you will find that there was practically no time that Founders General went consistently long with the stock of its parent, which I would not advocate.

Appendix T

STATEMENT OF ROYAL E. T. RIGGS, COUNSEL TO THE FOUNDERS COMPANIES, CONCERNING NONPAYMENT OF TAX ON $5,619,384 REALIZED BY UNITED FOUNDERS CORPORATION FROM THE RECEIPT AND SALE OF RIGHTS TO SUBSCRIBE TO THE STOCK OF UNITED STATES ELECTRIC POWER CORPORATION [1]

Mr. Riggs. When the matter first came up, sometime in October, Mr. Carron informed me that the accountants had advised him that the rights to subscribe to a third corporation stock issued by one company to its stockholders under the income-tax law constituted income to the recipient of the rights, at their market value upon the date of their receipt, whether exercised or not, and upon that basis United Founders would have set up on its books the market value of rights of American Founders it received up to the date when they were received. It seemed to me that might place upon the books of United Founders an item of income which might not be realized and might not be available for dividends, in that if the stock should depreciate in value, the value of the rights would be wiped out, and if it should go up in value and sell at an additional profit, that would show a profit less than actually received.

I told Mr. Carron, so far as I was concerned, I believed the rights ought to be sold. The next I heard of the matter was a letter from Mr. Carron dated November 12, 1929, which I have here, in which he says:

> Again referring to the rights which United Founders received on its holdings of American Founders common to buy shares of United States Electric Power at $15. The way we handled these rights on the books of United Founders was as follows:
>
> Immediately upon receipt of the rights we get up their market value of $6 per right on the books charging "Accrued Income Receivable" and crediting "Dividends Received." This put into dividends received account an income item which could not strictly be considered as cash income. However it was done so that we could meet the rulings of the Treasury Department which say that such rights are income at the value at the time received and are to be considered as dividends; and as dividends they are therefore not taxable on the Income-tax return of a corporate shareholder. The United Founders has not, therefore, set up any Federal income-tax liability on the value of these rights. The value of the rights incidentally was about $5,616,000. This amount is in our income account but, as just explained, there is no tax liability against it.
>
> Aside from the matter of income tax it was felt that the income as set up could not truly reflect cash income and should not be taken into our undivided profits available for distribution as dividends. We therefore converted the value of these rights into cash by selling them. It appears that we sold them at the same price of $6 per right as we set up on the books. When the shares were sold for cash we debited cash and credited accrued income receivable.

[1] Public Examination, American General Corporation, et al., at 26363 et seq. For discussion of this subject, see supra, p. 2319 et seq.

> The present status of these rights on the books of United Founders Corporation is therefore that of a cash dividend received from another domestic corporation which properly appears in our income account but for which we have no tax liability.
>
> Is in your opinion the above procedure correct, because if by any chance these rights are not to be considered as a dividend then we have realized $5,616,000 in cash which if not a dividend would probably then be profits. If it is to be regarded as profits then a 12 per cent tax thereon would be about $674,000. If there should be such tax liability then the way we now stand we are overstating our net income by $674,000.

That letter is dated November 12, 1929.

Immediately upon receipt of the letter I turned it over to one of my partners, Mr. William L. O'Conner, because I was busy with other matters, and asked him to get in touch with our tax consultants, Mr. Harry J. Richardson, of whose firm Mr. Roper, the Cabinet Officer was then the head. We never advised the Founders Group with reference to its taxes, its income taxes. That had always been done by other persons than our own firm.

Mr. O'Conner laid this entire matter before Mr. Richardson, went into it very carefully, and Mr. Richardson reported to Mr. O'Conner, and he will come here and so testify if desired, but in his opinion the receipt of these rights and the sale constituted a dividend which should be included in the dividend account, and for which there was no tax liability.

The income report of the corporation for 1929 was submitted to the United States Internal Revenue Department, and the value of the sale of these rights included as a dividend, accepted by the Department, and the income tax irrevocably closed on that basis.

When it came to the annual report for 1929, it was prepared in proof form and sent around to the directors individually. There was no meeting of the directors which passed upon the annual report prior to its being sent out to the shareholders, but the report was sent around to the directors, certified by the accountants, and they examined—I personally examined the text and took the certification of the accountants and the segregation of the earnings and so forth as they were made, from the accountants exactly as they were submitted.

When the matter came up at the directors' meeting on January 12, it had appeared previously, perhaps two or three weeks before, that this sale had been made to Investment Trust Associates and the stock purchased back from Investment Trust Associates, which had appeared in this letter of November 12, and the explanation was placed upon the minutes with a full explanation of it, and the first communication we had to the shareholders after the issuance of that annual report in March, 1930, Mr. Seagrave pointed out that the item of dividends did include a large amount of these rights which naturally could not be expected to be declared again.

Now, I have an opinion from the accountants, Messrs. Clarke, Oakes & Greenwood, that in their opinion the receipt of the rights was a proper credit to dividends, and further that in the publication of the statement of dividends, without distinguishing them from dividends in actual cash, that was a proper way to render the report.

In my opinion, if it had been called to the attention of the directors by the accountants in the proofs that were sent around, in my opinion it could have been better segregated and explained where the item came from.

Mr. STERN. I would like to question the accountants but, with your statement, I don't believe we need go further.

Mr. RIGGS. And Mr. Richardson will be glad to testify as to the advice he gave, and the reason we consulted Mr. Richardson was there were a good many people thought these rights ought to be treated in a different way. Some individuals didn't like the idea of crediting income account.

Dividends were taxable to individuals and lots of individuals didn't like the idea of crediting their income account with the value of the rights as of the date received, and paying a tax whether they exercised them or not. Therefore, we thought it was better to get impartial, outside advice and follow it, which we did.

Mr. STERN. Mr. Riggs, it is fair to say that you didn't necessarily condition your bookkeeping on the tax——

Mr. RIGGS. We wanted to condition our bookkeeping so we would not pay a tax of $674,000.

Mr. STERN. That is one thing, but it is desirable that you don't inflate your income account to the extent of $5,000,000 without letting your stockholders know.

Mr. RIGGS. This was circulated and initialed by the directors without a meeting. We accepted it as it came from the accountants.

Appendix U

DETAILED TESTIMONY OF LOUIS H. SEAGRAVE WITH RESPECT TO DEALINGS OF INTERNATIONAL SECURITIES CORPORATION OF AMERICA IN STOCK OF INVESTMENT TRUST ASSOCIATES [1]

Q. Isn't it true, Mr. Seagrave, that the statement that "Investment Trust Associates was formed as a Massachusetts trust in 1924 to operate as a securities holding corporation," [2] either had no meaning here or it implied continuity?

A. No; I don't agree with you, Mr. Stern; that is your apparent interpretation, but it is not mine. I think it merely stated a fact in an abbreviated way, and it was a fact.

Q. Well, I wonder whether the purposes to which this corporation was devoted, don't indicate that the reference to 1924 was an intentional reference to imply continuity? The fact is, isn't it, that International Securities Corporation could invest only in securities of companies that had been organized for a certain period of time, four years; isn't that right?

A. That is right.

Q. The investment restriction forbidding investment in securities unless the securities shall have been established for a period of at least four years was operative?

Mr. Riggs. Unless the corporation shall have been established.

Mr. Stern. Unless the corporation shall have been established for a period of at least four years.

Now, despite that restriction, International Securities Corporation did invest in the securities of Investment Trust Associates which had then been newly formed as a trust for American Founders Corporation purposes in 1928; isn't that right?

The Witness. Well, it hadn't been newly formed. It was formed in 1924, and its declaration of trust was filed then. It was amended from time to time. The company was not formed anew; it was formed in 1924.

By Mr. Stern:

Q. So that the formation in 1924 was highly relevant for your purposes?

A. I don't know what you are talking about; it was formed in 1924. There was a statement in the circular that it was formed in 1924. I have testified, and no one that I know of ever was in the slightest doubt that that was taken over as a trust shell, and a name, which was attractive, and which we wanted to use. The company was a holding company, it had been a private holding company with a good many preferred shareholders, its assets had been paid out and we wanted to retain it, and that is all that the effort was, to tell the dealer that.

Now, that was an actual fact. International did make an investment in this company, in this trust, and it did make an investment in I. T. A. on the basis of its having been in existence for four years. Technically, I think it complied with the restrictions. There was a feeling then already that that restriction

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[1] Public Examination, American General Corporation, et al., at 22972, et seq. For discussion, see supra, p. 2344 et seq.

[2] This statement was contained in a confidential circular to dealers at the time of the reorganization of Investment Trust Associates. (Public Examination, American General Corporation, at 22968.)

of International's was a detriment to it, and here was a case where a technical compliance—and I will admit only a technical one—was found in Investment Trust Associates.

Q. Well, for reasons that we will explore in a minute, I don't agree that was even a technical compliance, but the point that I am now interested in is that if it hadn't been for the fact that this had been a private holding company of Mr. Coombs' that had taken over margin accounts, and had represented the Managers in various matters, if it hadn't been for this 1924 factor, International couldn't have invested in the securities of that trust?

A. That is right.

Q. So that the 1924 factor was a perfectly relevant matter in connection with Investment Trust Associates?

A. We had a restriction and lived up to that restriction in a technical way.

Q. In other words, as you stated, one of the reasons for creating Investment Trust Associates, or taking it over, one of the reasons for taking over Investment Trust Associates was that it had technically a history of four years?

A. That it had been formed in 1924.

Q. Now, Mr. Seagrave, isn't there something essentially evasive, to use as colorless a term as I can use in this connection, about taking a shell of a company that has nothing but a corporate existence and a corporate name, that is about to be devoted to an entirely different business, and calling that a corporation that has been organized for four years?

A. Mr. Stern, I don't think so. You apparently do and I don't. I think that International Securities Corporation had these restrictions; I think that we all thought that it was desirable for it to make an investment in the type of company that we expected Investment Trust Associates to be. I think this was an opportunity for a technical interpretation and that was the one that was taken. But it was not a company that had been in a particular enterprise, just going along smoothly for four years. If it had been, there would have been earnings, statements and balance sheets and all that sort of thing. It was simply a shell, a name, but it had actually been formed in 1924. And we took advantage of that fact and that enabled International to make an investment. It was very much talked about at the time, considered by the trustees and all that, and that is the interpretation that they put on the restriction, and decided to do it, and thought it would be a good thing for the company.

Q. Did counsel approve of this course of procedure?

Mr. Riggs. I think I did, Mr. Stern. I must take my share of the responsibility with reference to it. It is always customary in any circular describing securities to give the date of the organization of the company. The dealers weren't interested in anything more than that. Every circular of almost any company that I have seen always gives the date of the organization of the company. Now, it was explained to me that this restriction about four years had been detrimental in some way to the interests of the Trust, in the opinion of the trustees, and further than that, there was no relaxation of any other restriction contemplated, of the fact that not more than 1¾ percent could be put into any one security, or 10 percent into any one distinct class, and the fact that it was a highly technical compliance with a restriction, which the trustees deemed to be detrimental to the Trust—I gave my approval to it upon that basis.

Further than that, the investment made by International in Investment Trust Associates common was considerably less than one percent of its entire assets, and upon which it made a substantial profit. Now, that is the only thing that I can say in palliation of the matter.

Appendix V

TESTIMONY OF ERWIN RANKIN OF THE INVESTMENT AND RESEARCH DEPARTMENT OF AMERICAN FOUNDERS CORPORATION, WITH RESPECT TO THE CONTRIBUTION OF HIS DEPARTMENT TO THE PROFITS REALIZED BY THE FOUNDERS SYSTEM IN THE YEARS 1928–1930 [1]

Q. Now, Mr. Rankin, I am interested in getting your point of view on this. I think it would be very valuable to the study. Do you think the advertisement the Founders Group, the real contribution that it made was in switching from one country to another, that it was so skillful that depressions made no difference to it, that they offered rather an opportunity to take out of a settled country and invest in a depressed country that showed signs of recovery, to what extent were those representations valid?

A. Until we ran into the depression culminating in 1932 there were real grounds for thinking that was quite a factor. The depression started in 1929 was much more a world-wide factor than I think we had ever experienced before, and even in that depression the way it hit the United States and the way it hit, for instance, England, were two quite different things. So, it is really a factor, a real factor. How closely an investment organization can do that I think is somewhat questionable under the present situation.

* * * * * * *

Q. The statement was made on November 12, 1929,[2] and I take it this was about the first very serious crash?

A. Yes, sir.

Q. "It has been demonstrated by generations of experience that business conditions and security values do not ordinarily fluctuate at the same time or in the same direction in the various countries of the world. While some are prospering, some are lagging behind; while some have more capital than they can possibly use, others need capital so badly they are willing to pay liberally for it, even on good security."

Then the statement continues:[3] "During its period of operation this group has experienced more than one complete investment cycle in each of several different countries. Any continued price recession in this country would give further favorable buying opportunities to our companies and your directors would be in a position to welcome such opportunities."

To what extent do you think the experience of the Founders Group has justified that statement?

A. I think up to that time it was very well justified. I think from that time on you run into two things that quite seriously militated against it; one was there being much more coordination between the depression that hit us that time than ever has been before, and second, the amount of capital that had been accumulated

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[1] Public Examination, American General Corporation, et al., at 24837.

[2] Remarks of the president of American Founders Corporation at a special meeting of stockholders. (Id., Commission's Exhibit No. X3841.)

[3] Ibid.

in the Founders made it rather more difficult to switch in that respect than had been through early cycles.

Q. When you say it had been justified up to that time, do you mean it had been justified in the results?

A. No; what I am thinking of—yes, I think even with the results in the 20's, even in my time, I think you could find occasions when that worked out splendidly. What I am thinking of is a study which was made by I think the National Industrial Conference, the National Bureau of Economic Research, Wesley Mitchell published a book on world-wide depressions and shows charts and how the cycles in the various countries compare with each other. I remember that very distinctly, that book——

Q. But what I am trying to get at is this * * *.

A. Which shows the cycles may vary tremendously between countries.

Q. I have no doubt the cycles may vary. The question is was the investment department able to take advantage of that variance?

A. Yes; I think what militated against us then would have militated against us somewhat even if we had not gone into such a serious depression over the world. In other words, we had a size capital that would have been left completely difficult to put entirely in a country.

Q. This shifting from country to country had not been tested as a matter of much importance as early as 1928?

A. I don't know whether any studies had been made of it, but we would rather constantly go into a country or out.

Q. What I would like to get right now is this statement was made in 1929. Also we have a statement in Commission's Exhibit 3842, a reprint from the United States Investor by Mr. Frank P. Bennett, Jr., which says:

"The series of stock market developments which represented a cataclysm for so many people were to the American Founders scarcely more than a normal incident in their scheme of operations."

Is that a fact?

A. If you speak, for instance, of the inflation in France and Germany, that is very much a fact. The history in the early 20's——

Q. (Interposing.) How about Americans? This was addressed to Americans. Do you think this was a fair statement of the case?

A. I would think it was; yes, sir. For instance up to the end of 1928 we had almost no assets in the United States, had withdrawn them, thinking that the market had reached apparent reduceless elevation. In 1929 with the influx of capital that came into the Group, we did go into the market on rather a short-term basis on what you would technically call trading, put out a great deal of cash and money on call all through that period. Now that was a case of withdrawing pretty much from the American Market and having it abroad.

Q. That takes us a little ahead of our story, but I would like to ask you, Mr. Rankin, isn't it true when American stocks were on the up grade in 1926, 1927, 1928? And (in) 1929, which was the beginning of the end, you were heavily in American stocks.

A. Yes; that is true because of the influx of capital and taking a temporary position.

Q. Viewing it in the larger sense, what contribution did you possibly render to the investors in the Founders Group when, we will say, you guess so badly wrong?

A. I don't think you would say we guessed so badly wrong. The whole market from practically 1926, 1927, 1928 and 1929 were all very fictitious markets in this country. We certainly had very few assets in the United States. If you combine in the Founders Group the investments in the special situations, and that is a

little beyond what I am thinking about, I presume if you do take that and take the formation of the U. S. Electric Power and figure that an investment in the United States, I think what you say would probably be all right, but thinking of it from the straight investment department angle, I think we handled ourselves pretty well in that way.

Q. Perhaps you did, Mr. Rankin, and perhaps I am not clearly understanding what you are saying, but the fact is that the general portfolio showed—perhaps we had better give you the profit figures from Exhibit 3732.

Take for example, take this over-all picture, 1928, 1929 and 1930. There was a total profit realized from the disposition of securities in the Group of $46,000,000 and over that period there was a total profit from the distribution of securities, those in the Group or otherwise of $43,000,000, so there was a net loss of $3,000,000 from general portfolio securities.

Were you acquainted with those figures?

Mr. RIGGS. Don't you think it fair to tell Mr. Rankin we don't agree to those figures?

Mr. STERN. You may tell him, Mr. Riggs, if you wish. This is the Exhibit and taken from the books and it shows the profits made in securities in the Group.

The WITNESS. This is American Founders Consolidated?

By Mr. STERN:

Q. This is a statement of all the different companies in the Group.

A. I see.

Q. Here is American Founders, take the total of American Founders. These are the companies, the names of the security, the horizontal line; the vertical lines are names of companies and profits and losses taken in those securities; and these are the totals for 1928. This is 1929 and this is 1930 and this last column here the totals for the three years, the grand totals.

Now you will observe that the over-all total here is $46,000,000 of profits taken by these various companies shown gross here, American Founders, Founders General, International, Second International, United States and British, American and General, United Founders and Investment Trust Associates in these securities, United Founders, American Founders, International and Second International and so on.

Now I want to ask whether that shows that the company was getting excellent results at that time from the shift from country to country or whether it isn't a fact that whatever profit was made, was made in this handling of the inter-company securities?

A. Well, it is very difficult for me to answer a question like that, seeing the presentation of such a mass of figures. I don't know when I saw a group of figures that way. I have a feeling you have taken both profits and losses on general portfolio and squeezed them into a net figure and compared it to profit and loss.

Mr. RIGGS. Exactly. Exactly. That is what they have done.

The WITNESS. You have these two years all practically losses in the general portfolio of all companies.

By Mr. STERN:

Q. Will you please explain what difference that makes assuming we have squeezed the general portfolio profits and losses all together, showing a single loss? How does that help the situation if there was a loss?

A. I don't think it helps the situation particularly, but it makes a curious looking set of figures that way. I confess I am very much surprised to see the size of the figures.

Mr. RIGGS. I am informed that we can and will present figures to show that during this period the gross profit taken some time or other in general portfolios of all companies amounted approximately to $18,000,000, most of which was counter-balanced by losses which took place after the crash in the market.

By Mr. STERN:

Q. I would like to know this——

Mr. RIGGS (interposing). In other words you have taken three years, and suppose now coming down to an absolutely net basis in that all of the profits made upon the portfolio in any one particular year have been counter-balanced by losses made upon the general portfolio in a later year.

Mr. STERN. No; in the same year.

Mr. RIGGS. The three-year period.

Mr. STERN. We have then totaled these figures and shown the totals for three years and we have the separate results for each year and they are all here.

By Mr. STERN:

Q. Mr. Rankin, what I am trying to get at is this. For several years, including 1929, including after the crash, the company was advertising that the depression made no difference, that depressions offered opportunities. On the other hand, in 1928, the experience of the American Founders showed that in its portfolio there was $30,000,000 of securities, that the general portfolio showed a book value of $14,000,000 and an appraisal of $14,600,000; an appraisal of $14,000,000 and unrealized appreciation of $617,000; that on the other hand the portfolio showed investments in subsidiary and affiliates of $15,000,000 making a total of $30,-000,000, and on those $15,000,000 there was an unrealized appreciation of $9,000,000.

Now does that bear any resemblance to the picture given in the speech I have read in your view?

A. Well, I think the two are rather different kind of things. You are taking a balance sheet position and talking about it as compared over a period of years shifting investments from country to country. I confess I don't quite follow the connections you are making on the general portfolio of the company you started with.

Q. The thing that is a peculiar phenomenon in connection with the Founders Group—I think I am stating this correctly; maybe I am not—is in no groups have we found this intercompany profit, profit made by the shifting of securities from one company to another company accompanied by a nondisclosure of the fact that these large profits were made in the securities of the group.

Mr. RIGGS. Now I would like to refresh Mr. Rankin's memory as to just what happened in 1928.

Mr. STERN. I will give you the opportunity, but I want to get Mr. Rankin's view at this time. If there is anything Mr. Rankin doesn't understand, you will be given an opportunity to examine him and he may make his explanation.

By Mr. STERN:

Q. What we really want to know, Mr. Rankin, is this, to what extent was the operation of the investment department a real part of the result in 1928, 1929 and 1930, which was the period of the great growth of Founders Group?

A. I wouldn't have said it was a fairly substantial part of it. Now, if you ask me over the whole picture from today back, I am not so sure.

Q. But taking the years 1928, 1929 and '30?

A. Yes.

Q. To what extent was it then a part of the general results?

A. Well, I should think it was really a part of that. Of course, you have picked years, particularly 1929 and 1930 when any investment organization had pretty bad losses in general portfolio. I confess I am astounded at the size of the figures, and I thought more of the intercompany transactions resulted more as an underwriting of the various companies.

Q. I think there are several features to that answer. Let us take them one at a time.

The period of 1929, it may have been unfortunate in the period of the greatest growth of the company there was a depression. I take it everybody agrees to that.

Second, so far as the depression having occurred, one of the things is to what extent would wise policy have been proper to meet the depressions?

What would you have done? Where did the investment [department] come in and to what extent were the investment department efforts, and to what extent were those efforts offset by other things, and is there anything you think an investment trust can actually do to protect people against times when protection is actually needed?

Let's start with the first. In the first place, do you think an investment company can actually give any service to people that will be useful to them when they are up against a depression?

A. Yes. I think it depends upon the individual's point of view very greatly whether he happened to be in the final equity or the senior equity and particularly how he is affected by the change in asset value, particularly when that has a market value superimposed upon it that acts very differently from the asset value. That can be very different in the holder's point of view, but the over-all picture of the investment company—it should be better—it should be able to do better than the individual investor.

Q. Were you acquainted with the representations being made to the public at this time?

A. I think I was; yes, sir.

Q. Were you acquainted with these general representations that Founders Group were panic proof, that panics were so much velvet to them, offering investment opportunities?

A. I think I was familiar with that.

Q. Let us address ourselves to that one representation. How true do you think that had proved in 1929?

A. Well, in my own mind I made quite a distinction up to 1929, and I would say up to that time it had been. Looking at it now I would say it had not been.

Q. Let us take 1929 when these various representations were made. Was that representation true at the time?

A. I think it was.

Q. What tangible results can you point to to indicate that representation was true when made?

A. That is what I was speaking of, the history, a concrete entire picture in the period of German and French inflation. I am going back over the whole period. You have asked me one year and I find it very difficult to answer.

Q. Let me call your attention, Mr. Rankin, to this.

A. You asked me for a concrete example where we did profit.

Q. I am asking whether it was true in 1929. Take 1929, you will find that out of the total profits from the dispositions of all companies was $38,000,000, and the total profits realized from the disposition of securities from Founders companies and other allied companies was $36,000,000. If you mean that the shifting from Investment Trust Associates to Founders General or from United Founders to

International or from United States and British to one of the other companies, the sale of those securities Founders generally was making a market for the public, if you mean that the statement was correct, but undoubtedly those were not shifted from one country to another.

Now what tangible thing can you point to to indicate that in 1929 that statement was true?

A. In one year I don't believe I can point to any shift as between countries to take advantage of conditions in a world-wide period of prosperity and depression. I don't think you could get that in any one year.

Q. The difficulty is I am possibly asking you about something with which you may have had a small part, but the fact is you were in the investment department and you were also a member of various executive committees?

A. Yes, sir.

Q. As I recall you stated you were more a part of the investment work of the company. Don't you think it is somewhat misleading when 36/38 or 18/19 [4] of the proceeds from the sales of securities, profit is made in the sale of the securities of the companies in the Group, that the speech stresses the panic-proof quality of your securities and lays no stress on the fact that 18/19 have come from dealing in these securities?

Mr. RIGGS. I must protest against this Exhibit and protest every time it is used as being completely unfair. As Mr. Rankin has pointed out, it includes profits made on underwritings of the issues of new securities by American Founders or United Founders underwritings of securities of companies newly formed and sold to the public.

For instance, take 1929, and you can check these figures afterwards. Our records show on the general portfolio of sales to the public the gross profits taken, including Founders General, amounts to $10,628,312.71. The corporation's losses amount of $5,360,507.17, leaving net profits of $5,267,805.54.

Now the profits on subsidiary securities as to the public amount to $18,981,411.90.

Mr. STERN. Is that on the initial distribution?

Mr. RIGGS. Yes. Sold within the group $6,182,899.25, profits on affiliated securities $5,753,318.72, sold within the group $2,653,000, a total of $8,971,000.68. I call your attention to the fact the net profits on general portfolio of over five million dollars was followed up by losses taken on the general portfolio under losses amounting to $8,750,284.07 in the year 1930.

Mr. STERN. Show us the basis you have in 1929, which is what we are talking about.

Mr. RIGGS. Well, Mr.——

Mr. STERN (interposing). Have you finished with your statement?

Mr. RIGGS. Yes. In 1928 our figures show even the gross profits of $3,507,-582.99 and the gross losses $490,635.77, leaving net $3,016,947.28.

Mr. STERN. We have a schedule showing the total profit as $7,292,000 and the total profit of subsidiary securities $4,275,000 in 1928.[5]

Mr. RIGGS. Our profits on subsidiary securities sold the public virtually $3,571,789.22, sold with the group $703,282.79, a total of $4,275,072.71.

In other words, our chief objection to this exhibit is it regards as intercompany profit, profit either made by United or American or Founders General in underwriting in selling the securities to the public, which was part of their business.

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[4] Reference is to the 1929 record of $36,000,000 realized by sales of Founders and allied company securities as compared to $38,000,000 realized from all sales. (Public Examination, American General Corporation, et al., Commission's Exhibit No. X3732.)

[5] See id., Commission's Exhibit No. X3732.

Mr. STERN. I think we have been over this before, Mr. Examiner. This does not purport to be purely a statement of any company's profit. It is the profits from dealing with securities in the group. It happens from $8,000,000 to $13,000,000 of these are pure intercompany profits, as we will show when we go into this with Mr. Seagrave, but the fact is as to the whole $43,000,000 of net profits the sales of securities from companies in that $43,000,000 represent profits from the sales of securities, that all that $46,000,000 is profit from sales of securities within the group or affiliates and that shows there was a realized loss of $3,000,000 on general portfolio and all the profits taken in those three years were the profits from the sale of securities in the group.

Now we haven't any quarrel with the fact that some of these came from underwritings and some came from distributing and trading. We have a very serious quarrel with the representations that were made by this company as to what it was doing and the nondisclosure of these items.

The EXAMINER. Items of what?

Mr. STERN. These items of income. You see in the first place it states in the record here that up to 1929 they had never segregated profits from trading from other income. After 1929 for the first time they segregated profits from trading from other income.

The EXAMINER. For instance, underwriting?

Mr. STERN. They just show income dividends and then segregate profits from sale of securities, profits on sale of investments, but then they never segregated profits from sales of their own securities, and not only did they not segregate in the statement sent out but continued to make representations. To understand Founders Group you had to understand its international position, and the fact you had possibilities of making profits, you could buy——

Mr. RIGGS (interposing). That is very loosely stated.

By the EXAMINER:

Q. Were you aware about this time a number of American investment companies by way of pamphlets and the like were saying that they never had a loss in forty to sixty years? You are aware of that?

A. I am aware of it; but it was a real-estate mortgage company.

Q. Even at the very time they were advertising by pamphlets and otherwise they had securities in default, dividends and interest were not being paid, but those bonds were being serviced and the holders of the securities were never apprised of the situation that existed. Was it common at that time to do things of that kind?

A. I don't know that it was particularly common. That was the situation not only with investment companies but with the banks.

Q. Do you see any difference in a situation of that kind and the advertisement of your shockproof service you were able to give?

Mr. RIGGS. I must protest, we didn't advertise shockproof or panicproof service.

The EXAMINER. That is my paraphrasing.

Mr. RIGGS. It is a little bit too strong.

The EXAMINER. If you object to it I would probably be the first to sustain your objection.

Mr. STERN. It is by no means too strong as we will probably show you.

Mr. RIGGS (reading).[6] "It has been demonstrated by generations of experience that business conditions and security values do not ordinarily fluctuate at the same time or in the same direction in the various countries of the world. While some are prospering, some are lagging behind; while some have more capital than

[6] Id., Commission's Exhibit No. X3841—Remarks of the president, American Founders Trust, stockholders' meeting, November 12, 1929.

they can possibly use, others need capital so badly that they are willing to pay liberally for it, even on good security."

I don't think anybody questions the truth of that. Even during the World War Norwegian and Scandinavian and American securities soared even in spite of what happened in Great Britain.

"During its period of operation this group has experienced more than one complete investment cycle in each of several different countries. Any continued price recession in this country would give further favorable buying opportunities to our companies and your directors would be in position to welcome such opportunities."[7]

Is that true? Had you in Germany, for instance——

The WITNESS (interposing). Taking the beginning of the trust, that is true.

By Mr. RIGGS:

Q. This was dated November 12, 1929. Did you believe that was true at the time?

A. Yes, sir.

Q. Did the investment department subsequent to that when it had very large amounts of money in call loans invest the money it had in call loans in marketable securities on the New York Stock Exchange believing they were favorable investments?

A. Yes, sir.

The EXAMINER. I don't believe the issue has been taken with all this statement.

Mr. RIGGS. I have read the paragraphs that are being criticized.

Mr. STERN. Not the only ones. It may be as a matter of abstract reasoning that your company did pass through periods of depression in other countries. The question we object to, the purpose behind our objection is that you were advertising your ability to deal with depressions and inflations when as a matter of fact any successes that the company had at that time was in dealing with its own securities in this country and I was wondering to what extent you personally knew that was the case.

Mr. RIGGS. I must say I don't think that statement is a fact.

Mr. STERN. Will you point out anything that isn't a fact?

Mr. RIGGS. The fact the company had been dealing in its own securities.

Mr. STERN. Read the last statement.

(The reporter thereupon read the statement referred to, as follows:)

"Not the only ones. It may be as a matter of abstract reasoning that your company did pass through periods of depression in other countries. The question we object to, the purpose behind our objection is that you were advertising your ability to deal with depressions and inflations when as a matter of fact any successes that the company had at that time was in dealing with its own securities in this country and I was wondering to what extent you personally knew that was the case."[8]

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[7] Ibid.

[8] See supra, p. 2352, for conclusion of Mr. Rankin's testimony on this subject.

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